

Assignments-of-Rent in Illinois (An Update)

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The continuing crazy quilt of assignment-of-rents decisions being issued by both state and federal courts (see in particular the goofy decision by the Third Circuit in *Sovereign Bank v. Schwab*, 2005 U.S. Lexis 13383 (6th Cir. 7/06/05)) highlights the desirability of adopting – sooner rather than later -- the new Uniform Access to Rents Act drafted by the National Conference of Commissioners on Uniform State Laws. Many judges still do not grasp the difference between “perfection” and “activation” of rents, and are totally confused by “absolute” v. “conditional” assignments of rents in connection with mortgage loans.

This issue has been heating up in Illinois recently. In *Randall Center Plaza Associates, L.P. v. First American Bank, SSB*, 2005 Bankr. LEXIS 1136 (N.D. Ill. June 6, 2005), the lender bank had a validly perfected mortgage and assignment of rents. After the debtor (a land trust) defaulted, the creditor commenced a foreclosure proceeding, obtained a third-party receiver, and purchased the property at a foreclosure sale after obtaining relief from stay from the bankruptcy of the debtor limited partnership that was the beneficiary of the land trust. The court held that the lender was entitled to obtain the rents from the property from September 2000, which was the date it gave notice of default to the debtor. (The debtor filed its Chapter 11 bankruptcy proceeding – later converted to a Chapter 7 liquidation – on July 1, 2003; the lender had obtained a receiver in April 2001 and took actual title to the property via foreclosure proceedings in April 2004). The court in *Randall Center* thus adopts a “relation back” approach to collection of the rents: although the lender did not “enforce” its right to the rents until it obtained “constructive possession” of the property by appointing a receiver, the right to the rents related back to the date of the notice of default delivered to the borrower-debtor.

The court ruled that the assignment-of-rents clause in the mortgage created a valid lien on the rents that the creditor properly “enforced” (and converted to ownership of the rents) by commencing foreclosure and obtaining a receiver (although the court cites, in support of this holding, a Seventh Circuit case, *Jones v. Stein (In re Fullop)*, 6 F.3d 422, 430 (7th Cir. 1993), which incorrectly states that “[a] creditor ordinarily *perfects* [as opposed to *enforces* or *activates*] a lien on rents . . . by initiating foreclosure proceedings that place it in actual possession of the real estate or requesting a receiver” (emphasis added)). The court in *Randall Center* noted that, “A mortgagee need not actually possess the property in order to collect on its assignment of rents. Rather, the modern trend is to permit a mortgagee to collect rents once it has taken constructive, as opposed to actual, possession of the property . . . For example, courts have allowed mortgagees to collect rents after the mortgagees have taken affirmative action to take possession of the property, by obtaining an injunction or by having a receiver appointed” (internal quotations and citations deleted). *Id.* at *16.

The assignment-of-rents provision in the mortgage stated that the mortgagor was granting the mortgagee an “absolute” assignment of the rents, but granted the mortgagor a “license” to collect the rents until the occurrence of a default under the mortgage, upon which the license would terminate and the lender “shall have the right . . . to collect the rents and profits, including those past due and unpaid.” The court (rightly) construed (although without specifically so holding) this language as nonetheless creating a conditional assignment of the rents that still had to be specifically enforced (or activated) by the lender before it would “own” the rents. But in any event the lender in this case had, as the court stated, “both initiated foreclosure proceedings and obtained the appointment of a receiver, the two ways that mortgagees may gain possession of property for collecting rent” (citations omitted). *Id.* at *18.

This case, unlike the *Sovereign Bank v. Schwab* Pennsylvania case, *supra*, involved a situation where there was a deficiency over and above the value of the property, which was the amount the lender bid in at the foreclosure sale. The total debt was approximately \$3.6 million, while the lender bid in \$1.5 million at the sale. According to the court in *Randal Plaza*, “While [the lender] cannot pursue [the debtor] for this amount, [the lender] may pursue [the shopping-center tenant] for unpaid rent that was due from September 2000 to April 2004, the amount of which is significantly less than the \$1.5 million balance on the loan. [The lender] may also pursue [the shopping-center tenant] for any unpaid rent due from April 2004 forward without regard to the deficiency balance from the foreclosure action.” *Id.* at *20.

See also In re Woodfield Gardens Associates, 1998 Bankr. LEXIS 640 (Bankr. N.D. Ill., May 28, 1998), at *37-39, where the court stated as follows:

The Debtor does not dispute that WHBCF [the lender] has a perfected first lien on the rents by virtue of its duly recorded mortgage, which contains an assignment of rents. The lien was recorded on November 30, 1984. See Exhibit No. 14 to WHBCF's Objection. Thus, WHBCF has priority over any attorneys' lien, either common law or statutory, that the Sachnoff Firm may have on the retainer by virtue of its holding the retainer. The Sachnoff Firm does not dispute this point. The pre-petition rents paid by the Debtor to the Sachnoff Firm held in the retainer constitute WHBCF's cash collateral because the funds were transferred after the Debtor committed the admitted default, thereby terminating the Debtor's authority to freely use the rents in accordance with the assignment of rents clause under the mortgage. This bankruptcy case was filed prior to any hearing on WHBCF's motion for possession, which, if granted, would have cut off the Debtor's rights to the rents. The Court was unable to find any Illinois case law directly on point, but 11 U.S.C. § 552(b)(2), in pertinent part, helps to provide the answer as a result of the 1994 amendments thereto:

(b)(2) Except as provided in sections . . . 506(c), . . . and notwithstanding section 546(b) of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to amounts paid as rents of such property . . . or other payments for the use or occupancy of rooms and other public facilities in hotels, motels or other lodging properties, then such security interest extends to such rents and such fees, charges, accounts, or other payments acquired by the estate after the commencement of the case . . .

11 U.S.C. § 552(b)(2). The legislative history makes it clear that the amendment was intended to expand the protection of the interests lenders may have in post-petition rents. Such logic applies to pre-petition rents as well. State law is relevant to determine if a lender has perfected its lien in pre-petition rents under *Butner v. United States*, 440 U.S. 48, 59 L. Ed. 2d 136, 99 S.Ct. 914 (1979).

It is undisputed that WHBCF holds a valid assignment of the rents from the Debtor. There is a divergence in the bankruptcy case law construing Illinois law on the steps a lien holder must take beyond a recorded assignment to preclude a reorganizing debtor's free use of the pre-petition rents post-petition. Compare *In re Gelwicks*, 81 B.R. 445 (Bankr. N.D. Ill. 1987) (DeGunther, J.) with *In re Cadwell Corners Partnership*, 174 B.R. 744 (Bankr. N.D. Ill. 1994) (Katz, J.) and *In re VIII South Michigan Assocs.*, 145 B.R. 912 (N.D. Ill. 1992) (Conlon, J.). The Seventh Circuit in *Wheaton Oaks*, however, makes it clear that rents subject to a recorded assignment of rents under Illinois law are cash collateral for purposes of §§ 363 and 552. 27 F.3d at 1243.

Interestingly, The Illinois Appellate Court in 1996 issued an opinion of great significance to commercial mortgage lenders in Illinois who take a separate assignment of rents from the mortgagor as additional security for the indebtedness. In *Comerica Bank - Illinois v. Harris Bank Hinsdale*, 284 Ill. App. 3d 1030 (Ill. App. Ct., 1st Dist. 1996), the assignment-of-rents document provided that the mortgagee could collect rents from the property without taking possession of the property, filing a foreclosure action, seeking the appointment of a receiver, obtaining court authorization, or taking any other enforcement action under the loan documents. The mortgagee had drafted the assignment-of-rents document in this way because of its belief that it was free to contract with the mortgagor for an “automatic” right to collect the rents upon the occurrence of a default, notwithstanding the Illinois common law requirement of possession of the property.

The appellate court ruled that because the subordinate lienholder had merely filed a foreclosure action and sought (but had not obtained) the appointment of a receiver, these actions did not constitute sufficient “affirmative action” that would entitle it to the

rents, i.e., the mortgagee must actually obtain prejudgment possession of the property through an affirmative ruling from the court on its foreclosure complaint or other filing (such as a request for a receiver or for injunctive relief) before it is entitled to collect the rents.

But in Illinois, the Conveyances Act was amended in 1996, at 765 ILCS 5/31.5, to provide that an assignment-of-rents instrument is perfected upon recordation whether the assignment is absolute, conditional, or intended as security, and that, “[u]nless otherwise agreed to by the parties, the mere recordation of an assignment does not affect who is entitled, as between the assignor and assignee, to collect or receive rents until the assignee enforces the assignment under applicable law” (emphasis added). The appellate court in *Comerica Bank-Illinois* did not mention or discuss this statute, presumably because the case had been decided by the trial court in 1994, before enactment of the statute. It certainly seems that the language quoted above may permit mortgagees to sidestep the problems associated with existing Illinois case law by following the strategy of the mortgagee in *Comerica Bank-Illinois* and specifically providing in the assignment-of-rents document that the appointment of a receiver, designation of the mortgagee as a mortgagee in possession, or other affirmative relief by the court is *not* necessary to enforce the assignment of rents. But there is as yet no case law to support this supposition.