

11-7-2011

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### Recommended Citation

Bernhardt, Roger, "The Priorities of Proceeds and Rents" (2011). *Publications*. Paper 470.  
<http://digitalcommons.law.ggu.edu/pubs/470>

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# The Priorities of Proceeds and Rents

By Roget Bernhardt<sup>1</sup>

When the Internal Revenue Service obtains a lien against a defaulting taxpayer, the Internal Revenue Code provides that the lien is invalid against holders of security interests until the Service has fled a public notice of the lien, an awkward way of saying that that a secured party who has already fled or recorded a security interest has priority over the government's tax lien. I.R.C. § 6323(a). This is pretty much a straightforward first to file or record principle written in taxpeak.

However, the Tax Code then goes on to add, as a twist, that the security interest must be already in existence in order to have the requisite priority, which it accomplishes by providing: "A security interest exists at any time (A) if, at such time, the property is in existence and the interest has become protected under local law against a subsequent judgment lien arising out of an unsecured obligation, and (B) to the extent that, at such time, the holder has parted with money or money's worth." § 6323(h)(1). That means that a security interest that otherwise predates a tax lien does not have priority if the collateral securing it was not also in existence before the tax lien was fled; earlier recorded secured parties do not win priority battles when after acquired collateral is involved.

How does that existence requirement play out as to rents generated under a mortgage that had been recorded *before* the tax lien was filed but that were not collected by the mortgagee until *after* the tax lien had been filed? There are fairly settled rules of priority as to rent claims in the real estate field for regularly worded mortgages<sup>2</sup>, but neither standard mortgage law nor typical rents clauses in mortgages add an existence requirement, such as § 6323 does. The interaction of real estate law and the special tax code requirement generated a question of first impression at the federal appellate level in *Bloomfield State Bank v United States*<sup>3</sup>, and was seized upon by Judge Posner of the Seventh Circuit as an opportunity to lecture the bar on some intriguing principles of economics.

## **Bloomfield State Bank v United States**

In *Bloomfield*, the bank had recorded its mortgage in 2004, the IRS had fled its tax lien in 2007, and the bank had a receiver appointed in 2008, who thereafter collected some \$82,000 in rents. The Service's argument that §6323(h)(1) defeated the bank's claim of priority to the rents, since they had not become "choate"<sup>4</sup> before the tax lien had been fled was accepted by the district court, but rejected

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<sup>2</sup> For instance, a mortgagee who has perfected its interest in the rents first has a prior claim to them—even as to rents not yet in existence—as against a mortgagee who perfected in them later (except for any rents properly collected by the second mortgagee before the first mortgagee bestirred itself into action).

The priority of mortgages against leases is an entirely separate matter, outside the scope of this column. See my column in the May 2008 California CEB Real Property Law Reporter, *When First Might Be Worst*, at [www.RogerBernhardt.com](http://www.RogerBernhardt.com).

<sup>3</sup> --- F.3d ---, decided May 11, 2011,

<sup>4</sup> Judge Posner tells us that he truly dislikes this word and intends never to have his court use it (because describing something as "choate" does not mean, as the rest of us may vulgarly suppose, that its characteristics are the opposite of "inchoate"; "inchoate" never meant "not choate", it being derived from what was, from the outset, a single integrated Latin word).  
Notwithstanding this illicit provenance, I find the word, and the concept, to be useful and to permit less awkward writing. (I would not want to have to call a particular asset "uninchoate"). Therefore, with apologies to the learned judge,

by the Court of Appeals.

The bank's security interest in the rents was prior, according to the Seventh Circuit, because the "property" required by §6323(h)(1) to be existence is the "source of value for repaying a loan in the event of default;... not the money the lender realizes by enforcing his security interest", i.e. not the rents but the real estate. Since the real estate that generated the rents had existed (and was encumbered) before the tax lien was filed, the bank had priority notwithstanding the choateness requirement of §6323.

Giving the bank priority in these circumstances is unremarkable, and should be comforting to private real estate lenders. It means that their rights to unaccrued rents are as well protected against the IRS as they are against bankruptcy trustees. Indeed, lenders look even better armed against the IRS than against bankruptcy trustees, since Bloomfeld Bank prevailed simply by virtue of having its real estate mortgage of record before the tax lien hit, whereas in bankruptcy fights, mortgagees have to rely on additional supportive federal and state legislation and the presence of complicated assignment of rents clauses (e.g., absolute but conditional on default) in their mortgages in order to shield those later rents from bankruptcy trustees.

### **Misgivings about the Reasoning**

Nevertheless real estate lawyers might be uncomfortable with the logic driving Judge Posner's decision. It is the logic of Article 9 of the Uniform Commercial Code, written for personal property transactions, being forced onto a real estate transaction. While Article 9 might very sensibly have been applied to real estate deals, the drafters carved it out<sup>5</sup>, and real estate judges have always preferred older and more arcane feudal property explanations for the results they reach, even when they are the same as what modern commercial judges would do.

For Judge Posner, the Bank's right to rents derived entirely from the fact that it held a security interest in the underlying collateral that generated those rents—the real estate. Rents were simply "proceeds" of that land. "[B]ecause the bank had a lien on the real estate, the rentals were proceeds." As he explains, "Whether the proceeds from the enforcement of a lender's lien take the form of sale income or rental income is a detail of no significance. To say that a parcel of land is "sold" rather than "rented" just means that the owner sells the use of the land forever rather than for a limited period. Sale income and rental income are just two forms of proceeds from land (or from improvements on it)."

That characterization means—for Judge Posner—that an assignment of rents clause is unnecessary, since the secured creditor has a claim on those rents anyway, as proceeds of the land. Indeed, a rents clause just confuses thinking on the issue:

"That would have been obvious in this case had not the mortgage contained a provision stating that rental income generated by the borrower's real estate was additional collateral securing the mortgage.

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I will continue to employ this "c" word, consoling myself with the knowledge that some of Judge Posner's colleagues on the Seventh Circuit (including Judge Easterbrook (see *U.S. v. Masters*, 978 F.2d 281, 1992), and even some justices sitting on the United States Supreme Court, have committed the same linguistic sin. See *U.S. v. Estate of Romani*, 523 U.S. 517, 1998).

<sup>5</sup> So Commercial Code §9-109(d) provides "This article does not apply to... (11) the creation or transfer of a lien on real property, including a lease or rents..."

The makes it seem as if the rental income is a distinct form of property rather than merely proceeds of owning a rental property. *Actually the rental income provision in the mortgage is a superfluity.* ”

### **The Role of Rents Clauses**

Is an assignment of rents clause in a mortgage really superfluous? Would all results be the same with or without it? It may have once been true that a mortgagee was automatically entitled to rents merely by virtue of holding a mortgage, but that was a very long time ago. Back in the times of Glanville and Bracton and Littleton, in the twelfth, thirteenth and fourteenth centuries, when mortgage documents were gages, or terms of years that expanded into fees, or conveyances of defeasible fee estates, generating corresponding rights to possession (and before courts of chancery were interfering with legal collection efforts), it was accurate to say that the mortgagee’s title to the mortgaged property entitled her to the possession of it, and thereby also entitled him to collect the rents generated from hiring out that possession to third parties.<sup>6</sup>

But two historical changes have made that statement inaccurate today. On the one hand, society no longer regards the collection of interest on a loan as usury per se; that ended in 1623. Creditors who had earlier been forced to demand possession in order to collect rents because it was the only way to collect the equivalent of interest on their loans<sup>7</sup> no longer had to use that device—they could simply loan on interest and let their debtors stay in possession. And, on the other hand, the displacement of the earlier title theory of mortgages by the more popular lien theory<sup>8</sup>, plus the intervention of equity<sup>9</sup> meant that a mortgagee could not acquire possession of the premises until after it had completed a foreclosure.<sup>10</sup> Since the right to rents depends on the right to possession, the lien theory effectively barricades mortgagees’ claims to rents during the life of their mortgages.<sup>11</sup>

### **The Need for a Rents Clause**

Given these barriers, a clause in the mortgage (or in a separate document) that provides access to rents sooner—say, on default—becomes an absolute necessity for a real estate lender. Without one, the mortgagor can stop paying the loan and pocket all of the rents (or worse, use them as a war chest to fight the mortgagee) during a prolonged foreclosure battle. The ability to write a good rents clause—one that permits enforcement immediately upon default and also makes the mortgagee’s rent claims superior to those of rival mortgagees and bankruptcy trustees—has been a source of major

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<sup>6</sup> See Burkhart, *Lenders and Land*, 64 Mo. L. Rev. 249, 1999.

<sup>7</sup> Which feature is what led to the labeling of these transactions as a *mort gages* rather than *vif gages* (wherein creditors collected the rents but then applied them to reduction of the debt, much less attractive than the mort gage, where they did not have credit debtors with those funds).

<sup>8</sup> Now the accepted doctrine in most American jurisdictions, including Indiana, where Bloomfield Bank operated.

<sup>9</sup> Denying the mortgagor the benefits of possession during the life of the mortgage comes dangerously close to impermissibly clogging his or her equity of redemption. See Shanker, *Will Mortgage Law Survive?*, 54 Case Western L. Rev. 63, 2003.

<sup>10</sup> Thus the Restatement of Mortgages, §4.1 provides “(a) A mortgage creates only a security interest in real estate and confers *no right to possession* of that real estate on the mortgagee.”

Even after a foreclosure, the mortgagee has no claim to the rents, unless it is also the foreclosure purchaser (and there is no post-sale right of redemption deferring rent collection even further).

<sup>11</sup> Comment b to the Restatement section just quoted adds, “This section does not limit the mortgagee’s ability to gain access to the rents and profits of the mortgaged real estate through enforcement of a mortgage on rents agreement or to secure the appointment of a receiver. Each of those remedies should stand on their own merits, unencumbered by the implications of the title-lien theory dichotomy.”

attention by the lending industry for the past few decades.<sup>12</sup>

(Article 9 suffers none of these problems. Unburdened by hundreds of years of history, the drafters of the Commercial Code were able to end run the concerns that plague real estate lawyers through the concept of proceeds<sup>13</sup>, providing that a security interest that attaches to collateral also gives the creditor the right to its proceeds<sup>14</sup>. As far as personal property is concerned, a creditor secured by collateral does not need to specially provide for the protection of the proceeds of that collateral.<sup>15</sup>)

Because a secured real estate creditor is not protected by a proceeds doctrine the same way that a secured personal property creditor is, rents clauses are necessary in land mortgages. Perhaps such a clause is unnecessary to resolve a priority battle with the Internal Revenue Service, but the clause would matter when the adversary is another real estate mortgagee. Outcomes would be significantly changed where one or the other of the mortgages lacked a property rents clause.<sup>16</sup> (Similarly, having properly perfected the right to rents would matter very much when the lender's adversary is a bankruptcy trustee, which is why so many states—including Indiana<sup>17</sup>, where this battle occurred—have enacted statutes designed to help lenders out in that regard.

### **The Uniform Assignment of Rents Act**

The new Uniform Assignment of Rents Act, adopted by the Uniform Law Commission in 2005, would make significant real change in this field, including bringing the treatment of rents closer to the way Article 9 treats rents.<sup>18</sup> Section 4(a) of UARA provides “An enforceable security instrument creates an assignment of rents arising from the real property described in the security instrument,

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<sup>12</sup> See, e.g., Forrester, *Still Crazy After All These Years: The Absolute Assignment Of Rents In Mortgage Loan Transactions*, 59 Fla. L. Rev. 487, 2007.

<sup>13</sup> § 9-102

<sup>14</sup> § 9-203. “As a result, a security interest in personal property collateral automatically extends to rents arising from that collateral, even if the debtor does not make an express assignment of those rents.” Wilson Freyermuth, *Modernizing Security in Rents: The New Uniform Assignment of Rents Act*, 70 Mo.L.Rev 1, 2006. Freyermuth was the reporter for this new Uniform Act.

<sup>15</sup> One of Judge Posner's examples (inadvertently) illustrates these differences: “Suppose that after the tax lien in this case attached in 2007, the receiver sold the mortgaged property for \$1 million. Would the IRS argue that its tax lien was prior to the bank's interest in the \$1 million? Of course not; the mortgage had been issued years earlier, secured by real estate then existing.” That might be true were this personal property, but, when it is real estate, I do not think that the mortgage would attach to the sales proceeds. Rather, the real property would remain encumbered by the old mortgage even though title was held by a new owner; cash paid for real estate is not generally treated as substitute security except when it is the result of eminent domain (where the government acquires both the title and the lien). Because insurance payments are not such substitute security, mortgages need to contain special provisions about those as well.

<sup>16</sup> See Restatement of Mortgages, §4.2, illustration 4, where, when the first lender's mortgage does not cover rents but the second lender's does, the second lender prevails as to those rents. (Illustration 5 adds the feature of the first lender then foreclosing, which thereby terminates the second lender's earlier right to rents. In Illustration 6, where a first lender takes a mortgage only on rents and a second lender takes a mortgage on the title, a foreclosure sale by the second lender will convey a title to the purchaser which will be subject to the senior mortgage on rents.) It is doubtful that these examples would make any sense in a pure Article 9 analysis, such as Judge Posner employs.

<sup>17</sup> See Indiana Code §32-21-4-2.

<sup>18</sup> The UARA does incorporate the concept of proceeds, which it defines as “personal property that is received or collected on account of a tenant's obligation to pay rents.” §2(10). That sounds close to, although not identical with treating rent as the proceeds of title or of the right to possession.

The Act also defines rents, separately from proceeds, describing them, as “sums payable for the right to possess or occupy, or for the actual possession or occupation of, real property of another person.” §2(12).

The California rents statute—Civil Code § 2938 - which first triggered action in this field in 1966, also used the term “proceeds”, but meant by it only what happened to rent moneys after they had been collected.

unless the security instrument provides otherwise.” This change clearly eliminates the need to draft an assignment of rents clause, although doing so more by way of making an assignment of rents provision an implicit part of a mortgage than by way of making rents simply the proceeds of the real estate collateral.<sup>19</sup>

However, UARA has been enacted only in Nevada (2007) and Utah. Other rent statutes still require or, at least assume, some sort of “written assignment of an interest in leases, rents, issues, or profits of real estate made in connection with an obligation secured by real property.”<sup>20</sup> Outside of Nevada, Utah, perhaps some archaic title theory courts, and perhaps also the Seventh Circuit, real estate mortgagees will not be able to reach the rents generated on their debtors’ properties before foreclosure unless their loan documents include the right clauses. Simply calling those rents proceeds of the collateral real estate will not do the trick.

### **Is UARA Likely to Fly?**

The history of real estate law is littered with the corpses of well meaning and well drafted proposed uniform laws that generated significant publicity on first appearance but then sunk quietly out of sight, with little or no legislative acceptance. (Witness the Uniform Land Transactions Act, The Uniform Simplification of Land Transactions Act, The Uniform Land Security Interests Act, and the Uniform Nonjudicial Mortgage Foreclosure Act.) Knowing that dissatisfied investors cannot just pick up their land and move it over to some other state with a more attractive legal system, there is little pressure on legislators or lawyers to argue for change from the old rules with which they are so deeply familiar (and with which lawyers from the big cities in other states are not).

It may also be true that there is no compelling case for national uniformity in the process of collecting rents after loan defaults, given that local counsel and local receivers are often best equipped to do that job anyway. But uniform or not, UARA does an excellent job of rationalizing a very messy field. WE should hope for its enactment, even if Judge Posner does not think that we need it.

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<sup>19</sup> The Official Comment to UARA §4 observes: “2. Rents as a distinct source of collateral.... By taking an assignment of rents, the assignee demonstrates its intention to have a lien upon all future rents arising from the real property, including those accruing prior to the completion of a foreclosure sale...”

<sup>20</sup> See, e.g., California Civil Code § 2938(a)(1)