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**HOW A PROPOSED NEW LAW MAY HELP COMMERCIAL MORTGAGE LENDERS  
WHEN THEIR BORROWERS DEFAULT**

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A new law now in the final stages of being written could streamline the ability of commercial mortgage lenders to control property income after default. This would give lenders more leverage against borrowers in default and help resolve loans faster, whether or not borrowers file bankruptcy.

The Mortgage Bankers Association has actively participated in drafting and commenting on the possible new law, by appointing the author of this report as the MBA's "observer" of that process. This does not necessarily mean the MBA will endorse the legislation or has any official views on it. As described below, however, the legislation will help commercial mortgage lenders in some important ways.

When a commercial mortgage loan goes into default, the lender wants to take control of property income as quickly as possible. This helps pay the loan. At least as important, if the lender can capture property income then the borrower can't use it to pay for a long fight with the lender. If the borrower must invest other money to pay for that fight, the borrower might not bother, especially if it knows the lender will almost certainly win at the end of the day. But if the borrower can simply divert property income to pay its lawyers, the fight becomes much less painful for the borrower. Therefore, any lender knows its loan documents and security package should choke off, and let the lender control, the property income as soon as possible after default.

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To achieve that result, present law often requires commercial mortgage lenders to comply with a sometimes strange and random set of rules that can vary from state to state, from judge to judge, and in bankruptcy.

A national group of legal experts, part of the National Conference of Commissioners of Uniform State Laws, is almost done writing and will soon propose legislation to simplify dramatically this entire body of law. The legislation, the Uniform Assignment of Rents Act, would tell lenders exactly what they must do to control various types of property income. And those steps will become easier than in the past. The legislation would give a borrower much less room to argue that a lender didn't do what it needed to do, or somehow doesn't have as much control over the property income as it wanted and thought it had.

Under existing law, some courts require a lender to jump through various hoops to take control of property income after a default. Sometimes those hoops are easy. Other times, they are difficult and time consuming, or uncertain and hence likely to produce issues and litigation. This is particularly true when the property income consists of something other than simple monthly rent payments from commercial tenants. For example, uncertainty often arises about income from a hotel, marina, parking garage, golf course, or any other type of real estate that might also be considered – at least partly -- an operating business.

The upcoming legislative proposal would cut through much of this complexity and standardize and simplify the rules on how a lender captures property income. The rest of this report describes some changes the Uniform Assignment of Rents Act will probably include.

Simpler Paperwork. Today, commercial mortgage lenders usually obtain both a mortgage (or deed of trust) and a separate “assignment of rents.” The legislation would do away with the second document. Everything could go in the mortgage.

For a large portfolio transaction, this change could save substantial time and expense in preparing, tracking, negotiating, revising, distributing, signing, acknowledging, recording, assigning, and releasing separate “assignment of rents” documents. In a multistate transaction, one less document would require review and comment by local counsel, and all the attendant phone calls, drafts, and coordination. By including the assignment of rents in the mortgage, the parties could devote time, money, and effort to more substantive issues in the transaction, closing it faster and at lower cost.

Commonsense Definition of “Rents.” The new law would define “rents” to include most income streams that a lender would intuitively think of as “rents” – but that some state courts have decided aren't really rents and are therefore (under the facts of particular cases) beyond the lender's control because the lender couldn't or didn't take the right steps to control them.

The legislation would define “rents” broadly, to include any payments made to occupy or possess real property. This would include hotel room charges, occupancy fees for a nursing home, and weekly or monthly docking fees at a marina. It would not include extra charges for services delivered to anyone paying “rent,” such as meal charges at a hotel, physicians' fees at a nursing home, or fuel charges at a marina. It would also not include payments for the short-term and non-exclusive “use” of real property, such as golfing fees or income from admissions to a concert or show.

By clearly and more broadly defining the scope of “rents,” the new law would give commercial mortgage lenders greater comfort and flexibility to finance assets that throw off income streams that might not precisely constitute “rent” as traditionally understood.

“Perfection” in Bankruptcy. The proposed new law could improve a commercial mortgage lender’s position when a borrower files bankruptcy, a common (and crucially important) step in the “end game” of any troubled real estate loan.

Although bankruptcy law generally requires bankruptcy courts to recognize a lender’s security interest in “rents” and similar income streams, that recognition may sometimes still be subject to provisions of bankruptcy law that would impair a creditor’s claim if, under state law, the lender had not adequately perfected its security interest as against future third parties.

Intuitively, one would think that recording a mortgage or an assignment of rents would suffice to “perfect” the lender’s claim. It usually will. But some state courts have required a commercial mortgage lender to take some extra step – appoint a receiver, send notice to tenants, take control or possession of the property, or take whatever other step the court decides the lender didn’t adequately take – before a lender could be deemed “perfected.”

If the borrower filed bankruptcy before the lender took these magic steps, then a bankruptcy court might allow the borrower to set aside the lender’s interest in the rents, giving the borrower control of the property income in the bankruptcy.

The proposed new law would say instead that if a lender records a mortgage, the lender is automatically “perfected” for all outstanding and future rents (broadly defined, as described above). The lender would unquestionably no longer need to take some other action under state law to take control of rents. This would prevent the bankruptcy courts from applying state law to set aside the lender’s claim to the rents based on the lender’s failure to have taken that magic special step.

Getting at the Rents. The proposed new law would unambiguously allow a mortgage lender to take control of the rents through several possible techniques, without risk of liability to the borrower or (in some states) risk of losing the ability to foreclose.

The lender could notify tenants, directing them to pay rent to the lender. Loan documents often give lenders this right, but they hesitate to use it and doubt it works. The new law would eliminate any uncertainty.

If a lender obtained a receiver for the property, the lender could unambiguously direct the receiver to pay the rents to the lender, typically after paying operating expenses. (Lenders usually already have this right, at least in states that make it easy for a lender to appoint a receiver. The new legislation would extend these principles to other states and also simplify and streamline the appointment of receivers.)

The lender could also give the borrower a notice, directing the borrower to pay rental income to the lender. If the borrower didn’t comply, the lender could obtain a judgment against the borrower. The lender could probably enforce that judgment against the borrower’s other

assets (or conceivably against the individuals who misapplied the rental income) even if the loan was otherwise nonrecourse, although this is not entirely clear.

In some states, lenders fear that if they try to take control of property income, they may lose the right to foreclose because of “one form of action” rules in the particular state. The proposed law would make it clear that if a lender takes control of property income, this does not limit the lender’s ability to foreclose. The lender remains free to pursue any other rights and remedies.

Similarly, the new law would make clear that by collecting the rents the mortgage lender does not somehow assume the obligations of a “mortgagee in possession” of the property. For example, the lender should not become liable for payment of the property’s operating expenses.

Considered as a package, the new law would simplify a commercial mortgage lender’s life, both in closing and documenting loans and in enforcing them if they go bad. The law would eliminate uncertainties that borrowers have used to cause delay and to apply rental income to pay legal fees rather than the money they owe their lenders. The new law would promote consistency and simplicity in dealing with “rent-like” streams of income, by treating them all as rent and defining exactly what a lender must do to control them.

The sponsor of the potential Uniform Assignment of Rents Act, the National Conference of Commissioners of Uniform State Laws, has circulated several drafts, including one earlier this year (available online at [www.law.upenn.edu/bll/ulc/maripp/jan05draft.pdf](http://www.law.upenn.edu/bll/ulc/maripp/jan05draft.pdf)). Those drafts reflect comments received from numerous sources, including the author of this report. The drafting committee will consider the proposed legislation in final form in late April 2005, then submit it to the Conference for final consideration in August 2005, after which it will be distributed to state legislatures to be considered and perhaps enacted. The author intends to submit final comments on the proposed legislation around March 15, 2005. Any MBA member with suggestions, questions, or comments on the legislation should contact the author at [joshua.stein@lw.com](mailto:joshua.stein@lw.com).