

SERVICING MANAGEMENT®

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The Servicer's Forgotten Remedy

If an income-generating property is the subject of a foreclosure, that source of income can potentially be turned over to the servicer.

BY BRUCE J. BERGMAN

In more than a few cases of a mortgage in default, a servicer's exercise of the assignment of rents provision in the mortgage can be a welcome ally - and even a potent weapon. It seems, though, that the remedy has somehow fallen below the radar, or at least is underutilized. So, understanding how and when to use it - taking into account its limitations - should be helpful.



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First, however, we offer a not uncommon scenario which highlights why the assignment of rents provision can be so meaningful to mortgage servicers. Assuming a borrower owns a two-family (or larger) home, we find that after default - and after ignoring all correspondence and calls designed to elicit a reinstatement or workout - the borrower launches a remorseless and unending attack upon the foreclosure action. Servicers have, of course, seen this before, and here are some of the possible events.

If in a judicial foreclosure state, the borrower somehow hides or disappears, making service of process lengthy, expensive and sometimes ineffectual. He denies receipt of the breach letter. His answer to the case recites a host of fanciful and blurry defenses. Motions to reargue are followed by appeals, motions for stays, disingenuous settlement negotiations, orders to show cause and multiple bankruptcy filings. (And there are some other tactics we

have not mentioned.)

Sometimes appearing without the aid of counsel to gain the extra consideration courts often grant the unrepresented, the borrower also engages an attorney at various times who seems to be effective at muddying the issues and slowing up the process.

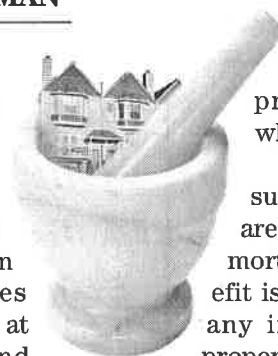
What's going on here, and where is a defaulting borrower finding the income to fund this powerful and seemingly interminable defense? The simple answer is the rental income of the premises - the money paid by the various tenants to the borrower/landlord.

Upon the supposition that the income greatly exceeds the cost of the defense, there is considerable incentive to fuel the fight as long as possible. Avoiding debt service, insurance and taxes can provide a pleasing profit month after month.

The provision

Here is where the assignment of rents provision comes in, because it is designed to cut off the income stream to the borrower. To avoid confusion, this invites comparison of three concepts related to collection of rents: mortgagee in possession, receivership and assignment of rents. The receivership is obviously the most common, and with good reason.

The receiver is an independent party (usually an attorney) appointed by the court (upon application) who is authorized to collect the rents, issues and profits of the mortgaged premises. Not incidentally, the receiver also



protects and preserves the property, making repairs when necessary.

At the end of the foreclosure, the net funds collected are applied in reduction of the mortgage debt. A corollary benefit is that the receiver cuts off any income stream from the property to the borrower, thus diminishing the will - and the funds - to forever delay the case. Also, the receiver must post a bond to provide recourse if he fails to discharge his duties or performs them negligently.

Less utilitarian is becoming a mortgagee in possession. In essence, the mortgagee itself can become a substitute for a receiver and take control of the premises. An immediately recognizable problem with that is liability - to say nothing of having qualified staff to oversee the task. Insurance helps, but the lender or servicer itself becomes responsible for repairs, any waste which occurs, accidents at the premises and the like. Not surprisingly, lenders and servicers would usually prefer the insulation of a receiver.

Finally, we come to the assignment

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of rents - the foundation of this review. The heart of the usual mortgage clause is the assignment of rents at the premises to the lender, but triggered only upon default. Whether this assignment is automatic upon default or requires an affirmative demand by the lender depends upon the wording of the provision.

A typical assignment of rents provision widely in use by servicers reads in part as follows: "Borrower absolutely and unconditionally assigns and transfers to lender all the rents and revenues ('rents') of the property, regardless of to whom the rents of the property are payable. Borrower authorizes lender or lender's agents to collect the rents, and agrees that each tenant of the property shall pay the rents to lender or lender's agent. However, borrower shall receive the rents until: (i) lender has given borrower notice of default pursuant to the security instrument, and (ii) lender has given notice to the tenant(s) that the rents are to be paid to lender or lender's agent. This assignment of rents constitutes an absolute assignment and not an assignment for additional security only."

This kind of clause will go on at some length to recite other points, critical among them that the lender is not required to enter upon the premises or take control of or maintain the property - a key consideration. The idea is to collect the rents without the obligation to be a manager of the property, as a receiver or mortgagee in possession would be.

So, assuming a lender or servicer wishes to avail itself of this remedy, as a practical matter a writing would be conveyed to the borrower exercis-

ing the assignment. Then letters would go to the various tenants demanding that rents be paid directly to the lender.

It should immediately be noted that there are some limitations to the potency of the remedy. If concepts surrounding assignments of rents are somewhat obscure among professionals, one can imagine how perplexed tenants would be when told to pay rent to someone other than their

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landlord. The response could be to ignore the demand from the lender or servicer and continue paying rent in the normal course. Experience suggests that while some tenants will pay the lender or servicer, others will simply seize the opportunity to pay no one. What then does the lender or servicer do?

The response leads to the ultimate shortcoming of the assignment of rents provision. As the law is in New York, for example, the servicer could initiate a suit against each tenant who has not paid to collect rents becoming due from the date of demand. Even if the tenants then pay, any future defaults would require future suits. More disconcertingly, the cost of these actions could be disproportion-

ately high, given the amount at issue.

Militating most strongly against using the assignment of rents: Eviction is not a remedy in some states (like New York). The assignee of the rents is simply not a landlord and, as an agent, has no right to possession. This remains so even if the assignment of rents clause also contains an assignment of lease aspect. This is wonderful in separating the servicer from liability, but less helpful on the collection side.

Even if some tenants don't pay, though, there is then a benefit if the case warrants appointment of a receiver. A receiver is empowered to collect all rents due at the time of his appointment. When a foreclosing plaintiff elects to pursue a receivership, how long the process takes can vary. If a servicer first exercises the assignment of rents - should the tenants react in the fashion of ceasing rent payments to anyone - there will be that much more rent "due," which the receiver can collect rather than the defaulting borrower.

In the end, employment of the assignment of rents provision is not a panacea. But it wasn't developed for that purpose and doesn't have to be. Where an income-generating property is the subject of the foreclosure and all the money is being captured by the defaulting borrower (to fund a defense or otherwise), that source of income can potentially be wiped out to the borrower and turned over to the servicer with considerable speed and minimal effort.

Such is the capability of exercising the assignment of rents clause. In proper circumstances, it is something to consider. **SM**