The 'Assignment Of Rents' Provision

It Usually Applies To Commercial Mortgages, But Can Apply To Residential Loans

BY BRUCE J. BERGMAN

As sophistication in lending and servicing increases with volume and exposure to new concepts, seemingly obscure corners of mortgage foreclosure procedure can become worthy of consideration.

One such concept is the assignment of rents provision which, although long a staple of commercial mortgage commerce, is only recently receiving some attention in residential lending and servicing circles. It's not for every case, but in selected instances it can have meaning. So, let us open the door.

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Virtually any mortgage will (or certainly should) contain an "assignment of rents" clause. In essence, the provision says that as further security for the mortgage, the borrower assigns to the lender the rents arising out of the property. (In a residential case, the two-family house would be the threshold.) The lender simultaneously waives those rents, but reserves the right to cancel the waiver and become entitled to that income in the event of default by the borrower.

(For larger or commercial mortgages, the provision, usually just part of the mortgage itself, is contained in a separately recorded instrument. That is done because for some bankruptcy purposes this independent recordation may be a prerequisite to assuring perfection of a security interest in the rents.)

Exercising the clause

If there is a default, exercising the assignment of rents clause is generally one of the more effortless tasks in the mortgage foreclosure process. Unless the mortgage itself provides to the contrary (which would be unusual) all that is required is an unequivocal letter to the borrower declaring that the lender has availed itself of the assignment of rents provision.

At the same time, a letter should be sent to the tenants so they have notice of their obligation to remit rent to the lender.

If the process is all so simple, why then does it remain, as we mentioned at the outset, so obscure? There are a few ready answers which perhaps become obvious upon analysis.

Even if the method is effective to garner rents for the lender, the clause affords no benefit for preservation of the property. While a *receiver* serves to both collect income and maintain the property, the assignment of rents applies only to the income side of the equation. And, a borrower denied the rents is even less likely to expend sums out of his own pocket to preserve the property.

Next, what might a tenant think when a demand is made by someone other than the landlord for payment of rent? Compound that inquiry with a likely statement by the owner/borrower to the tenant that the lender's request is ridiculous and unfounded. The net result is that many,

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or most tenants, will not pay rent to anyone.

A sticky wicket

Such an apparently unsatisfactory response has a dual residual benefit, though.

■ First, it denies a portion of the income stream to the borrower, thus tending to reduce the zeal to obfuscate or litigate.

■ Second, it leaves available a pool of income for a later appointed receiver to seize, which is generally the recommended procedure. (Remember, a receiver is entitled to collect all rent *due* or to become due.)

Yet another infirmity in the assignment of rents scenario is the limited remedy available if the lender does wish to pursue the tenant who declines to pay rent.

Because the lender does not become the landlord (which is probably welcome), no landlord-tenant relationship exists. Consequently, no summary proceeding to obtain possession can be brought; only an action for a money judgment for rent is available. *[Reference **Poughkeepsie Sav. Bank v. R&G Sloan Mfg. Co., Inc.**, 84 A.D.2d 212, 445 N.Y.S. 2d 560 (3d Dept. 1981).]* The time and expense to sue for relatively minor sums, then hoping to collect, would assuredly be discouraging.

But all this leads to an emerging and very exciting principle, the relationship of assignment of rents to creating recourse on a non-recourse mortgage!

To explain, well drafted commercial mortgages increasingly contain what are sometimes referred to as "carve out provisions". The mortgage is non-recourse, i.e., no personal liability for the debt, except to the extent the borrower does certain things, such as fail to pay taxes or commit waste at the property.

A new case from New York is an enlightening example, and it may represent a trend. *[Reference **Connecticut Mutual Life Ins. Co. v. 2770 Broadway Associates**, N.Y.L.J., Jan. 5, 1994, at 22, Col. 6 (Sup. Ct., N.Y. Co., Cahn, J.).]*

There, the mortgage documents provided that the lender waived the right to pursue a deficiency judgment against the borrower. But, the mortgage also said that such limitation on liability would not apply "if and to the extent that the mortgage (d) misapplies or misappropriates condemnation or insurance proceeds attributable to all or part of the mortgaged property, or (e) commits fraud or misrepresentation."

There was also a typical assignment of rents clause.

Upon the inevitable default, the lender sent a notice to the borrower, demanding that the borrower advise the tenant to pay rent directly to the lender. Not only did the borrower fail to comply, but it continued to collect rent for four months - amounting to $400,000.

In the foreclosure, the lender sought a deficiency on the theory that the borrower's failure to notify the tenant to pay rent to the lender was a misapplication of funds. The court agreed, although limited the deficiency which could be pursued to the amount of the rents collected after receipt of notice - all this even though the mortgage was otherwise non-recourse.

The ultimate lesson? Even non-recourse mortgages can benefit from some wise and appropriate carve out provisions, which can also protect a lender seeking to enforce the assignment of rents clause.

The legal principles discussed in this article are derived from law and practice in New York. They should, nevertheless, be of rather wide application, but local statutes and case law should always be consulted. SM