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FNMA v. Bugna: California Assignment of Rents Provision and the Impact of the Bankruptcy Reform Act of 1994

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**FNMA V. BUGNA: CALIFORNIA
ASSIGNMENT OF RENTS PROVISION AND
THE IMPACT OF THE BANKRUPTCY
REFORM ACT OF 1994**

I. INTRODUCTION

California courts have traditionally interpreted assignment of rents provisions in an incoherent and confusing fashion. On August 29, 1997, in *Federal National Mortgage Ass'n v. Bugna*,¹ the California Court of Appeal for the Fourth District joined past courts in this vexatious tradition. The court held that a lender who is a beneficiary under a recorded assignment of rents agreement must take an enforcement step, such as demanding the rents after the borrower defaults, before the lender can acquire a present possessory right to collect the rents.

This decision is disagreeable to lenders because the end result is unjustly determined by who can run the fastest. If the lender does not have an automatic present possessory right to collect the rents post-default than the lender must race to enforce the assignment of rents before the debtor files for bankruptcy. Often times the lender is left standing at the starting line while the debtor is running its victory lap because it filed for bankruptcy immediately after it defaulted.

The solution to this problem is obvious. Once a lender records an assignment of rents it automatically acquires a present possessory interest in the rents which the lender can exercise immediately upon the borrower's default. In other words, once the borrower defaults, it is no longer entitled to collect the rents as they automatically become the property of the lender.

This Note addresses the problems California lenders have in protecting their security interest in rents. Section II briefly describes different assignment of rents provisions. Section III discusses the facts

1. 57 Cal. App. 4th 529, 67 Cal. Rptr. 2d 233 (1997).

of *Bugna*. Section IV details the reasoning of the court of appeal for its decision in *Bugna*.

Section V provides a historic analysis of the assignment of rents issue in both state and federal court. It explores the legislative intent behind the enactment of former California Civil Code sections 2938 and 2938.1 which was the state's attempt at regulating rents. Section V also examines new California Civil Code section 2938. In addition, this section discusses Congress's intent in enacting the Bankruptcy Reform Act of 1994, specifically the amendment to 11 U.S.C. § 552 titled "Postpetition effect of security interest." Section V also considers how academics and practicing attorneys interpret the amendment to 11 U.S.C. § 552 as well as certain bankruptcy courts' interpretation of the amended statute.

Section VI analyzes whether the court of appeal correctly interpreted California state law in its decision in *Bugna*. Section VI also examines the possible outcome of *Bugna* had it been decided under applicable bankruptcy law. Additionally, section VII proposes a solution for California lenders to avoid arguing with courts over their interest in the rents. This Note concludes by arguing that the *Bugna* court misinterpreted and ignored applicable law, and should therefore be discredited as reliable authority for future decisions.

II. ASSIGNMENT OF RENTS DEFINED

An assignment of rents is an agreement whereby a lender loans a borrower money to purchase income-producing property, and requests that, as additional security for the loan, the borrower assign the rents to the lender.² There are three different types of assignment of rents agreements:³

(1) An "absolute" assignment of rents allows the lender to immediately start collecting rents on the property.⁴ Typically, the lender would be responsible for collecting the rents each month and would deposit them into a bank account. The lender would then

2. See Robert C. Leibsle, *Enforcing Assignments of Leases, Rents and Profits*, 69 WIS. LAW. 26, 26 (1996).

3. See Richard L. Wynne & Stuart J. Wald, *Assignments of Rents: Absolute or Non-Absolute? Cash Collateral or Not? Some Musings on the State of the Fight*, in "RENTS" IN BANKRUPTCY - NEW FRONTIERS 1 (The Orange County Bankr. Forum ed., 1997); see also, Leibsle, *supra* note 2, at 26 (describing the three different types of assignments).

4. See Wynne & Wald, *supra* note 3, at 1.

withdraw the loan payment before permitting the borrower to use any of the money.⁵

(2) A "collateral" assignment creates a future lien in favor of the lender, where "the rents are considered additional collateral for the loan."⁶ Additionally, "the lender or an appointed receiver must take physical possession of the property before any rents may be collected by those parties."⁷

(3) A "conditional absolute" assignment passes "title" of the rents to the lender when the borrower and lender enter into an agreement.⁸ However, the lender allows the borrower to collect and use the rents as long as the borrower does not default on the loan.⁹

The issue presented in *Bugna* was how the assignment of rents ripened into a present possessory interest in the rents upon the borrower's default. In other words, the court had to decide at what point the lender acquired a present possessory interest in the rents.

III. STATEMENT OF THE CASE

In 1986, Randolph C. Bugna ("Bugna") borrowed \$5,315,000 from Federal National Mortgage Association ("FNMA") so that he could purchase an apartment complex.¹⁰ As security for the loan, Bugna executed a note and trust deed in favor of FNMA.¹¹ Paragraph 26 of the trust deed included provisions for an assignment of rents.¹²

5. *See id.*

6. *Id.*

7. *Id.*

8. *See id.* at 1-2.

9. *See id.*

10. *See* Federal Nat'l Mortgage Ass'n v. Bugna, 57 Cal. App. 4th 529, 531, 67 Cal. Rptr. 2d 233, 234 (1997).

11. *See id.*

12. Paragraph 26 provides in pertinent part:

As part of the consideration for the indebtedness evidenced by the Note, Borrower hereby absolutely and unconditionally assigns and transfers to Lender all the rents and revenues of the Property, including those now due, past due, or to become due Borrower hereby authorizes Lender or Lender's agents to collect the aforesaid rents and revenues and hereby directs each tenant of the Property to pay such rents to Lender or Lender's agents; provided, however, that prior to written notice given by Lender to Borrower of the breach by Borrower of any covenant or agreement of Borrower in this instrument, Borrower shall collect and receive all rents and revenues of the Property as trustee for the benefit of Lender and Borrower, to apply the rents and revenues so collected to the sums secured by this Instrument in the order provided in paragraph 3 hereof with the balance, so long as no such breach has occurred, to the account of Borrower, it being

In 1987 Bugna conveyed the apartments to his spouse Mary Bugna ("Mary") along with some other properties.¹³ In 1988 Bugna's other creditors, *not* including FNMA, filed an involuntary Chapter 7 proceeding against him.¹⁴ The bankruptcy trustee ("trustee") objected to the transfer of the apartments to Mary, and the court entered a judgment on December 1, 1992, that nullified the transfer and reinvested title in Bugna.¹⁵ Upon reinvestment, the apartments became an asset of the bankruptcy estate and the trustee took possession and started collecting rents.¹⁶

Bugna did not default on his loan with FNMA until October 1, 1992.¹⁷ On December 3, 1992, FNMA sent a written notice to both Bugna and Mary stating that it was exercising its rights under the deed of trust to collect rents and revenues of the apartments.¹⁸ The next day FNMA filed an action for judicial foreclosure¹⁹ and notified

intended by Borrower and Lender that this assignment of rents constitutes an absolute assignment and not an assignment for additional security only. Upon delivery of written notice by Lender to Borrower of the breach by Borrower of any covenant or agreement of Borrower in this Instrument, and without the necessity of Lender entering upon and taking and maintaining full control of the Property in person, by agent or by a court-appointed receiver, Lender shall immediately be entitled to possession of all rents and revenues of the Property as specified in this paragraph 26 as the same become due and payable, including but not limited to rents then due and unpaid, and all such rents shall immediately upon delivery of such notice be held by Borrower as trustee for the benefit of Lender only; provided, however, that the written notice by Lender to Borrower of the breach by Borrower shall contain a statement that Lender exercises its rights to such rents. Borrower agrees that commencing upon delivery of such written notice of Borrower's breach by Lender to Borrower, each tenant of the Property shall make such rents payable and pay such rents to Lender or Lender's agents on Lender's written demand to each tenant therefor

Id. at 531-32, 67 Cal. Rptr. 2d at 234.

13. *See id.* at 532, 67 Cal. Rptr. 2d at 235.

14. *See id.*

15. *See id.*

16. *See id.*

17. *See id.*

18. *See id.*

19. *See id.* When a debtor defaults on its obligations under the note, the beneficiary of a deed of trust can enforce its lien on the underlying property in a judicial foreclosure. *See* Stephen P. Milner et al., *Foreclosures, Private Sales and Deeds-In-Lieu in California: Understanding and Planning for the Debtor's Tax Consequences*, 22 CAL. BANKR. J. 161, 161 (1994). In order to accomplish this the beneficiary obtains a court judgment ordering the sale of the property. *See id.* The sale is conducted by a levying officer and the proceeds are then applied to reduce the debt. *See id.* If the proceeds are not enough to cover the indebtedness the beneficiary may obtain a deficiency judgment. *See id.* at 163.

Mary that it was requesting the appointment of a receiver to take over the apartments.²⁰

Unfortunately, FNMA was not aware of the December 1st judgment that revested the property in Bugna.²¹ When FNMA learned of the judgment, it realized that the automatic stay in bankruptcy would prevent the appointment of a receiver to take possession of the property.²² Consequently, FNMA could no longer pursue a judicial foreclosure action.²³ FNMA contacted the trustee and reasserted its security interest in the rents from the apartments and requested that rents collected by the trustee be safely kept for FNMA's benefit.²⁴

On October 6, 1993, the bankruptcy court granted FNMA's request for relief from the automatic stay, thereby permitting FNMA to pursue state court remedies.²⁵ A few weeks later, FNMA filed an action in state court for judicial foreclosure and requested that the state court appoint a receiver.²⁶ Pursuant to FNMA's request, the court appointed a state court receiver effective November 1993.²⁷ The trustee continued to collect rents from the apartments until November 1993.²⁸ With permission from the court, the trustee abandoned the apartments and stopped collecting rents because he believed that the sale of the apartments would not yield enough equity for the bankruptcy estate.²⁹ The trustee transferred more than \$337,000 in rents collected to the state court receiver in December 1993.³⁰

20. See *Bugna*, 57 Cal. App. 4th at 532-33, 67 Cal. Rptr. 2d at 235.

21. See *id.* at 533, 67 Cal. Rptr. 2d at 235.

22. As soon as a voluntary or involuntary bankruptcy petition is filed, the automatic stay is effective.

This automatic stay prohibits creditors from taking virtually any collection action against the debtor The automatic stay prohibits litigation for pre-bankruptcy debts, enforcement of judgments against the debtor, any action against the debtor or the estate's property (the action prohibited includes obtaining liens, perfecting liens or enforcing liens), and any act to collect from the debtor.

Patrick A. Randolph, Jr., *When Should Bankruptcy Courts Recognize Lenders' Rents Interests?*, 23 U.C. DAVIS L. REV. 833, 837 & n.17 (1990); see 11 U.S.C. § 362(a)(1)-(6) (1993).

23. See *Bugna*, 57 Cal. App. 4th at 533, 67 Cal. Rptr. 2d at 235.

24. See *id.*

25. See *id.* at 533 n.1, 67 Cal. Rptr. 2d at 235 n.1.

26. See *id.*

27. See *id.* at 533, 67 Cal. Rptr. 2d at 235.

28. See *id.*

29. See *id.*

30. See *id.* at 533, 67 Cal. Rptr. 2d at 235-36.

In March 1994, FNMA nonjudicially foreclosed³¹ on the apartments and received a credit bid³² that was \$1.3 million short of the amount due on the note.³³ FNMA requested a state court order requiring the receiver to forward to FNMA any rents the receiver had in its possession, including the rents transferred to the receiver by the trustee.³⁴ Despite Bugna's objection, the trial court granted FNMA's request and gave the state court receiver permission to forward the rents to FNMA.³⁵

Bugna appealed the trial court's decision and asserted that FNMA should not receive the rents collected before November 8, 1993.³⁶ Bugna argued that before this date FNMA had not made a *valid* written demand informing him that FNMA was exercising its right to collect rents as required by paragraph 26 of the deed of trust.³⁷ In response to Bugna's assertion, FNMA argued that "no written demand is necessary because on default [FNMA] is automatically entitled to all post-default rents without the necessity of a written demand."³⁸

The court of appeal stated that FNMA had a "perfected security interest in the rents."³⁹ Nonetheless, the court found that the deed of trust required "an additional step—making a written demand exercising its rights—to enforce that security interest; therefore FNMA is entitled only to those rents collected after the demand was made."⁴⁰

31. *See id.* The beneficiary under a deed of trust may choose to hold a private sale upon the debtor's default. *See Milner et al., supra* note 19, at 163. The property is sold at a public auction after proper notice has been given to both the public and the debtor. *See id.* The court is not involved in a nonjudicial foreclosure, and the beneficiary cannot get a deficiency judgment if the sale price is insufficient to cover the indebtedness. *See id.*

32. "A secured creditor has the right to 'credit bid' its lien on the property. Thus, a secured creditor can purchase property subject to its lien by being the high bidder and paying cash only to the extent that the purchase price exceeds the amount of its liens." Allan S. Brilliant, *Sale of Assets in Bankruptcy, in DOING DEALS 1997: UNDERSTANDING THE NUTS AND BOLTS OF TRANSACTIONAL PRACTICE 1045, 1050* (PLI Corp. Law & Practice Course Handbook Series No. B4-7168, 1997).

33. *See Bugna*, 57 Cal. App. 4th at 533, 67 Cal. Rptr. 2d at 236.

34. *See id.* at 534, 67 Cal. Rptr. 2d at 236.

35. *See id.*

36. *See id.*

37. *See id.*

38. *Id.*

39. *Id.*

40. *Id.*

IV. REASONING OF THE COURT

A. Trust Deed Required FNMA to Make a Written Demand Notifying Bugna of its Exercise of its Rights to Rents

The court first interpreted the parties' contract as a whole.⁴¹ In addition, it resolved any ambiguities in the contract against FNMA, because the trust deed used was a standardized contract drafted and selected by FNMA.⁴² The court next interpreted the terms of the contract, specifically paragraph 26 of the deed of trust:

Our review of paragraph 26 as a whole convinces us written notice of default and demand for rents is the event defining the date FNMA becomes entitled to the rents. Paragraph 26 refers to delivery of "written notice" on several occasions and states that "prior to delivery of written notice" borrower may collect and receive the rents. It then provides that "[u]pon delivery of written notice" FNMA becomes entitled to "possession of all rents and revenues . . . as the same become due and payable, including but not limited to rents then due and unpaid, and all such rents shall immediately upon delivery of such notice be held by Borrower as trustee for the benefit of Lender only." This language does not provide that rents collected *before* notice is given (i.e., rents no longer due and unpaid) are held by borrower for FNMA. Finally, the trust deed contains instructions on how rents "collected subsequent to delivery of written notice" shall be applied, but is silent on how rents collected prior to that notice should be applied, strengthening the interpretation that rents collected prior to the notice are not due FNMA.⁴³

FNMA argued that upon default Bugna automatically became a trustee for FNMA and collected the rents solely for FNMA's benefit.⁴⁴ FNMA also argued that the only purpose for the written demand was to terminate Bugna's right to collect the rents.⁴⁵

The court held that FNMA's interpretation of the provision in the deed of trust was incorrect.⁴⁶ "The express language of paragraph 26 states that *upon notice* FNMA is entitled to 'due and payable'

41. *See id.* at 535, 67 Cal. Rptr. 2d at 236.

42. *See id.*

43. *Id.* at 535, 67 Cal. Rptr. 2d at 237; *see supra* text accompanying note 12.

44. *See Bugna*, 57 Cal. App. 4th at 535-36, 67 Cal. Rptr. 2d at 237.

45. *See id.* at 535, 67 Cal. Rptr. 2d at 237.

46. *See id.* at 536, 67 Cal. Rptr. 2d at 237.

rents and that 'such rents,' which do not include previously collected rents, shall be held by Bugna as trustee for FNMA '[u]pon delivery of written notice.'⁴⁷

FNMA cited *In re Scottsdale Medical Pavilion*⁴⁸ to reinforce its position that Bugna's right to retain the rents automatically terminated upon default.⁴⁹ In *Scottsdale*, the Ninth Circuit Bankruptcy Appellate Panel ("Panel") held that a debtor's right to keep the rent for his own benefit automatically terminates at default, even though the debtor can still collect the rent after default.⁵⁰ The Panel held that these post-default rents collected by the debtor were subject to the creditor's security interest even if the creditor had not taken any enforcement steps.⁵¹

The *Bugna* court stated that *Scottsdale* was inapplicable because the Panel decided *Scottsdale* under Arizona law and FNMA made no effort to analogize Arizona law and California law.⁵² In addition, the *Bugna* court stated that it could not tell whether the language in the security agreement in *Scottsdale* included a "written notice" requirement as did the language in paragraph 26.⁵³

*B. Under Former California Civil Code Sections 2938 and 2938.1
the Assignment of Rents was Ineffective Until FNMA Took
an Enforcement Step*

The *Bugna* court next analyzed the issue of enforcement under California law. The court stated that it found the holding of *In re GOCO Realty Fund I*⁵⁴ to be persuasive since that case applied California law to a trust deed containing provisions similar to paragraph 26 of the deed in this case.⁵⁵ The *GOCO Realty* court analyzed former California Civil Code section 2938(b)(2)⁵⁶ and came to the conclusion that:

47. *Id.*

48. 159 B.R. 295 (B.A.P. 9th Cir. 1993).

49. *See Bugna*, 57 Cal. App. 4th at 536, 67 Cal. Rptr. 2d at 237-38.

50. *See Scottsdale*, 159 B.R. at 301.

51. *See id.*

52. *See Bugna*, 57 Cal. App. 4th at 537, 67 Cal. Rptr. 2d at 238.

53. *Id.*

54. 151 B.R. 241 (Bankr. N.D. Cal. 1993).

55. *See Bugna*, 57 Cal. App. 4th at 537, 67 Cal. Rptr. 2d at 238.

56. "[N]otwithstanding any provision . . . that would otherwise preclude or defer enforcement of the rights granted the assignee . . ." CAL. CIV. CODE § 2938(b)(2) (West 1993) (repealed 1996).

[t]he literal words of the statute plainly anticipate an enforcement step by a lender who holds legal title to rents arising from a perfected conditional absolute assignment of rents before the lender is entitled to possession However, the language of the statute leaves ambiguous the question of entitlement to rents after perfection but before enforcement of the assignment.⁵⁷

The *GOCO Realty* court resolved this ambiguity by defining perfection as a protection of the lender's security interest from an intervening third party.⁵⁸ The court further stated that if the lender wanted to acquire the actual right to collect the rents it must take an additional enforcement step. Until that time the borrower is entitled to the rents collected before the enforcement step is taken.⁵⁹

In support of its position, the *GOCO Realty* court cited numerous California cases and secondary sources, and concluded that "a lender's right to possession of rents arises only upon both the borrower's default *and* the lender's demand for possession. Although Cal.Civ.Code § 2938 may obviate the need for a further perfection step, it cannot be read to obviate the need for a further enforcement step."⁶⁰

The *Bugna* court stated that under the 1996 amendment to Civil Code section 2938, a lender must take some perfection step after the borrower defaults, such as writing a demand letter, before a lender can exercise its entitlement to the rents.⁶¹

The 1996 amendments to section 2938 were designed to avoid the confusion which plagued the courts in this area by providing: (1) the assignment is a present assignment regardless

57. *GOCO Realty*, 151 B.R. at 247 (emphasis omitted).

58. *See id.* at 248.

59. *See id.*

60. *Id.* The *Bugna* court's reliance on *GOCO Realty* as persuasive authority was severely misguided. The *GOCO Realty* court in its holding completely ignored former California Civil Code section 2938 and its legislative intent. The court acknowledged that the statute was "intended to strengthen real estate lenders' claims to rents in bankruptcy." *Id.* at 247. It also stated that former section 2938 codified the holding of *In re Ventura Louise*, 490 F.2d 1141 (9th Cir. 1974). *See id.* The *GOCO Realty* court interpreted the *Ventura Louise* holding as stating that an absolute assignment of rents transfers title to the lender and obviates the need for a further perfection step by the lender before it is entitled to collect the rents. *See id.* Nevertheless, the *GOCO Realty* court ignored all of its discussion above and relied on an 1898 case, which required an enforcement step, as persuasive authority. *See id.* at 249 (citing *Bank of Woodland v. Heron*, 120 Cal. 614, 52 P. 1006 (1898)).

61. *See Bugna*, 57 Cal. App. 4th at 538, 67 Cal. Rptr. 2d at 238-39.

of the language used to create it (subd.(a)); (2) the assignment is fully perfected when properly recorded (subd. (b)); and (3) upon default the creditor could collect rents which accrued but were unpaid and uncollected “[o]n and after the date the assignee takes one or more of the enforcement steps” described in subdivision (c), such as making demand for the rents on the borrower (subd. (c)(4)). Thus, the new statute clearly provides that a creditor holding an absolute assignment is not entitled to rents collected prior to the date it takes one of the enforcement steps.⁶²

C. Former Section 2938 Did Not Eliminate the Need for an Enforcement Step

FNMA stated that the legislative history of former section 2938 supports its finding that the section eliminated the requirement of an enforcement step to terminate the debtor’s right to rents.⁶³ Moreover, FNMA stated that the purpose behind section 2938 was to “strengthen a lender’s position against a bankruptcy trustee by conferring ‘perfected’ status to liens created by an ‘absolute assignment conditional on default’ clause.”⁶⁴

The *Bugna* court reasoned that even though section 2938 provided a statutory grant of perfection against third parties, this did not eliminate the need for the enforcement step.⁶⁵ In contrast to FNMA’s assertion, the court believed that the legislative history supported the finding that an enforcement step was still necessary.⁶⁶ Although the court recognized that the initial proposed language⁶⁷ of the statute

62. *Id.* at 538 n.6, 67 Cal. Rptr. 2d at 239 n.6 (citing Norma J. Williams et al., *Assignment of Rents—The Next Generation*, 15 CAL. REAL PROP. J. 27, 33-34 (1997)).

63. *See id.* at 539, 67 Cal. Rptr. 2d at 239.

64. *Id.* (citing Sylvia P. O’Neill, *Assignment of Rents: Mystery or Enigma?*, 10 CAL. REAL PROP. J. 20, 21 (1992)).

65. *See id.*

66. *See id.*

67. The proposed language reads as follows:

Notwithstanding the fact that an assignee may be required to enforce its perfected interest in the rents by notice or through the appointment of a receiver . . . , the assignor who has granted an assignment of rents . . . shall collect the rents, issues and profits that are the subject of the assignment as agent for the assignee, and the assignee’s interest in the rents, issues, and profits shall continue in the rents, issues, and profits collected by the assignor

Id. at 539, 67 Cal. Rptr. 2d at 239-40 (quoting California SB 326, as introduced Feb. 11, 1991, 1991-92 Reg. Sess. 2-3).

was consistent with FNMA's argument, opponents criticized the language⁶⁸ and the drafters later deleted it.⁶⁹ The court stated that the deletion of the proposed language "constitutes strong evidence that the act as adopted should not be construed to incorporate the original provision."⁷⁰

Lastly, FNMA argued that in *MDFC Loan Corp. v. Greenbrier Plaza Partners*,⁷¹ the court held that former section 2938 "eliminates the need for the lender to take steps beyond recordation of the trust deed to be entitled to enforce its interests in post-default rents."⁷²

The *Bugna* court addressed this issue by distinguishing *MDFC* on its facts. In *MDFC*, when the borrower ("Greenbrier") defaulted, the lender ("MDFC") recorded a notice of default and election to sell under the deed of trust.⁷³ MDFC then filed an action for judicial foreclosure and specific performance. It further sought the appointment of a receiver to take control of the property and collect the rents.⁷⁴ On February 20, 1991, the day after the court granted MDFC's request for the appointment of a receiver, one of Greenbrier's general partners filed an involuntary Chapter 11 petition which placed Greenbrier in bankruptcy.⁷⁵ MDFC requested that the bankruptcy court dismiss the proceeding and, on October 10, 1991, the court granted its request.⁷⁶ The receiver that the court appointed

68. The proposed language was criticized by a committee staff report as follows:

Case law holds that the mortgagee is entitled to rents only from the date of his demand. Thus, case law does not allow the creditor to automatically claim rents as far back as the date of default. This provision would do so. This added ability of the lender to reach more funds would mean less funds for the debtor and the unsecured creditors. **WOULD NOT THIS PROVISION ESTABLISH AN UNEQUAL PLAYING FIELD FAVORING LENDERS?**

Id. at 539-40, 67 Cal. Rptr. 2d at 240 (quoting CALIFORNIA SENATE COMM. ON JUD., REPORT ON SB 326, APR. 9, 1991 HEARING, 1991-92 Reg. Sess. 4 (citation omitted)).

69. *See id.* at 540, 67 Cal. Rptr. 2d at 240 (citing California Senate Amendment to SB 326, Apr. 23, 1991, 1991-92 Reg. Sess.).

70. *Id.* (quoting *WDT-Winchester v. Nilsson*, 27 Cal. App. 4th 516, 534, 32 Cal. Rptr. 2d 511, 521 (1994) (quoting *Central Delta Water Agency v. State Water Resources Control Bd.*, 17 Cal. App. 4th 621, 634, 21 Cal. Rptr. 2d 453, 459 (1993))).

71. 21 Cal. App. 4th 1045, 26 Cal. Rptr. 2d 596 (1994).

72. *Bugna*, 57 Cal. App. 4th at 540, 67 Cal. Rptr. 2d at 240.

73. *See MDFC*, 21 Cal. App. 4th at 1048, 26 Cal. Rptr. 2d at 598.

74. *See id.*

75. *See id.*

76. *See id.*

on February 19, 1991, took control of the property and began to collect the rents.⁷⁷

During the period that Greenbrier was in bankruptcy—from February 20, 1991 to October 10, 1991—Greenbrier collected \$328,528.07 in rent from the property.⁷⁸ After the court dismissed the bankruptcy case Greenbrier refused to transfer the collected rent to the receiver.⁷⁹ Greenbrier then brought suit against MDFC in state trial court and requested a temporary restraining order to prevent MDFC from holding a nonjudicial foreclosure sale of the property.⁸⁰ In order to bring suit the court required Greenbrier to deposit the disputed rents with the clerk of the court at which time the clerk transferred the rents to the receiver by stipulation of the parties.⁸¹

Greenbrier lost its suit against MDFC and, therefore, MDFC held a nonjudicial foreclosure sale.⁸² After the sale, the trial court terminated the receivership and ordered the receiver to disburse the total funds, \$413,554.85, to Greenbrier.⁸³ MDFC appealed the trial court's decision.⁸⁴

The issue in *MDFC* was whether former California Civil Code section 2938 entitled MDFC to all the rents collected after appointment of the receiver.⁸⁵ The appeals court stated the statute entitled MDFC to exactly that.⁸⁶ The appeals court held that:

[o]nce Greenbrier defaulted on the loan, a perfected transfer of the property's income arose in favor of [MDFC], and it sought to enforce the transfer by filing this action and seeking the appointment of the receiver. Thus, [MDFC] is entitled to all of the funds held by the receiver when the receivership was terminated.⁸⁷

The *Bugna* court asserted that *MDFC* did not address the same issues as those in *Bugna*.⁸⁸ In *MDFC* there was no claim by Greenbrier that MDFC had failed to take an enforcement step or that it

77. *See id.*

78. *See id.*

79. *See id.*

80. *See id.* at 1049, 26 Cal. Rptr. 2d at 599.

81. *See id.*

82. *See id.*

83. *See id.*

84. *See id.* at 1049-50, 26 Cal. Rptr. 2d at 599.

85. *See id.* at 1050, 26 Cal. Rptr. 2d at 599.

86. *See id.*

87. *Id.* at 1052-53, 26 Cal. Rptr. 2d at 601.

88. *See Bugna*, 57 Cal. App. 4th at 540, 67 Cal. Rptr. 2d at 240.

had failed to make a timely demand for the rents from the property.⁸⁹ The *Bugna* court argued that it applied section 2938 consistently with *MDFC* by holding that the statute entitled the lender to post-default rents after the lender took an enforcement step.⁹⁰

The *Bugna* court concluded by reiterating its reasoning, “[w]e conclude the enactment of section 2938 did not alter existing California law requiring that a lender holding a perfected security interest in rents must take some form of an enforcement step to terminate the borrower’s right to post-default rents.”⁹¹ Therefore, by finding that *MDFC* was distinguishable on its facts the *Bugna* court dismissed the logic in *MDFC* and held that FNMA should not have received the disputed rents.⁹²

V. STATUTORY HISTORY OF ASSIGNMENT OF RENTS

The modern difficulties associated with the protection of a lender’s security interest in rents began in 1979 when the United States Supreme Court held in *Butner v. United States*⁹³ that state law should govern the validity and enforceability of security interests.⁹⁴

The Supreme Court advised that bankruptcy courts should take all necessary steps to guarantee that they afford the mortgagee the same protection in federal bankruptcy court as it would have under state law if no bankruptcy had ensued.⁹⁵ The main reason the Supreme Court did not want to establish a uniform federal rule regarding assignment of rents is because it did not want to encourage forum shopping.⁹⁶ The Supreme Court feared that a creditor who failed to take the appropriate steps to meet the requirements of a state statute would file an involuntary bankruptcy proceeding against the debtor.⁹⁷ Consequently, the creditor would benefit from a federal rule automatically respecting the creditor’s right to rents.⁹⁸ “Thus, a federal

89. *See id.*

90. *See id.*

91. *Id.* at 540-41, 67 Cal. Rptr. 2d at 240.

92. *See id.* at 541, 67 Cal. Rptr. 2d at 240.

93. 440 U.S. 48 (1979).

94. *See id.* “The justifications for application of state law are not limited to ownership interests; they apply with equal force to security interests, including the interest of a mortgagee in rents earned by mortgaged property.” *Id.* at 55.

95. *See id.* at 56.

96. *See* Kathryn R. Heidt, *The Effect of the 1994 Amendments on Commercial Secured Creditors*, 69 AM. BANKR. L.J. 395, 401 (1995).

97. *See id.*

98. *See id.*

rule that changes state law could cause parties to forum shop by choosing bankruptcy."⁹⁹

The Supreme Court reasoned that:

Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum shopping, and to prevent a party from receiving "a windfall merely by reason of the happenstance of bankruptcy."¹⁰⁰

In reliance on *Butner*, bankruptcy courts looked to state law when determining the validity of a security interest under an assignment of rents provision.¹⁰¹ In *Butner*, the Supreme Court acknowledged that Congress has constitutional authority to establish uniform laws on the subject of bankruptcies.¹⁰² It stated that this authority would "clearly encompass a federal statute defining the mortgagee's interest in the rents and profits earned by property in a bankrupt estate. But Congress has not chosen to exercise its power to fashion any such rule."¹⁰³

The case history regarding the protection of a lender's security interest in post-petition rents is contradictory and confusing.¹⁰⁴ For example, in bankruptcy cases certain courts decided that when the debtor grants an "absolute" assignment of rents, the rents are outside the bankruptcy estate and the lender may simply collect them.¹⁰⁵ If

99. *Id.*

100. *Butner*, 440 U.S. at 55 (quoting in part *Lewis v. Manufacturers Nat'l Bank*, 364 U.S. 603, 609 (1961)).

101. See John Collen & Douglas Rosner, *Protecting Assignments of Rents in Bankruptcy: The Case for Following In Re KNM Roswell*, 20 CAL. BANKR. J. 197, 198 (1992).

102. See *Butner*, 440 U.S. at 54.

103. *Id.*

104. See Paul P. Daley et al., *Rents: When Are They Cash Collateral?*, in REAL EST. WORKOUTS & BANKR. 1992, 773, 784-85 (1992).

105. See *id.*; see also *Federal Deposit Ins. Corp. v. International Property Management, Inc.*, 929 F.2d 1033, 1038 (5th Cir. 1991) (concluding that an absolute assignment of rents automatically gave the lender the right to the rents when the debtor defaults); *In re Ventura-Louise Properties*, 490 F.2d 1141, 1145 (9th Cir. 1974) (holding that the lender was not required to enter the premises prior to collecting the rents under an absolute assignment).

the debtor grants a "collateral" or "conditional" assignment of rents, the courts' decisions have typically fallen into four categories.¹⁰⁶

Some courts found that the recordation of the assignment of rents perfected the lender's interest in the rents.¹⁰⁷ Other courts held that the lender's recordation of the assignment of rents was enough for the lender to perfect its interest in the rents even though the lender may not have taken the necessary steps to enforce its rights to the rents under state law.¹⁰⁸

In contrast to this deference to lender's rights, certain courts required that, in order for a lender to protect its post-petition security interest in the rents, the lender must take some pre-petition action.¹⁰⁹ This action could consist of requesting that a receiver be appointed to collect the rents or the lender actually taking possession of the property.¹¹⁰ Finally, other courts allowed lenders to perfect their interest in the rents post-petition by filing a motion that qualifies as a notice under 11 U.S.C. § 546.¹¹¹

This confusion regarding assignment of rents was frustrating for lenders and courts. Therefore, both the California Legislature and Congress enacted statutes in an attempt to clarify the confusion surrounding the perfection of an assignment of rents.

A. State Legislative History

Traditionally, California embraced a lien theory of mortgages.¹¹² The lien theory of mortgages impacts a creditor who holds a lien on

106. See Daley, *supra* note 104, at 785.

107. See *id.* at 785, 788; see also, *In re Somero*, 122 B.R. 634, 638-39 (Bankr. D. Me. 1991) (reasoning that recordation completely perfects a lender's rights to rents).

108. See Daley, *supra* note 104, at 785, 789-92; see also *In re Rancourt*, 123 B.R. 143, 148 (Bankr. D. N.H. 1991) (deciding that, while the recordation of the assignment of rents is not sufficient to allow the lender to enforce its rights to rents, the recordation does protect the lender's interest in post-petition rents).

109. See Daley, *supra* note 104, at 785.

110. See *id.* at 785, 792-96; see also, *In re Concord Mill Ltd. Partnership*, 136 B.R. 896, 900 & n.9 (Bankr. D. Mass. 1992) (requiring that the lender make a ceremonial entry to assert its right to possession of the property and requiring that the lender take possession of the property if the debtor permits).

111. See Daley, *supra* note 104, at 785, 796-99; see also *In re Harbour Pointe Ltd. Partnership*, 132 B.R. 501, 504 (Bankr. D. D.C. 1991) (establishing that the lender's filing of an adversary proceeding to protect its security interest in the rents was sufficient to qualify as notice under 11 U.S.C. § 546(b)).

112. See Sara H. Reynolds, *A New Look at Secured Creditors' Rights to Rents and Profits: Is the Pendulum Swinging Back?*, 15 CEB REAL PROP. L. REP. 257, 259 (1992).

real property by disallowing a right to possession of the property until the creditor has foreclosed its lien.¹¹³ Therefore, a creditor with a security interest in rents “has merely an inchoate lien and the debtor in possession may continue to collect the rents and profits . . . [until the creditor] take[s] steps to ‘perfect’ its interest in rents beyond merely recording its assignment of rents.”¹¹⁴ This perfection of the creditor’s security interest does not occur until the creditor takes possession of the rents either personally or through a court appointed receiver.¹¹⁵

Over time, California developed two distinct assignment of rents provisions that differ slightly from the national model. California developed both an “absolute” and “additional security” assignment model.¹¹⁶ In California in an “absolute” assignment, the borrower actually transfers its interest in rents or profits to a lender.¹¹⁷ Conversely, in an “additional security” assignment the borrower merely promises its interest in the rents to the lender, but does not actually transfer its interest to the lender.¹¹⁸ An “additional security” assignment models the lien theory of mortgages, where the lender cannot collect the rents until it takes additional steps to perfect its interest in the rents.¹¹⁹

The type of provision used determined what legal status California law applied to the lender.¹²⁰ This differentiation had significant legal consequences for the lender if the borrower filed for bankruptcy.¹²¹ Under an “absolute” assignment the lender perfected its interest in the rents when it recorded the assignment.¹²² Therefore, if the debtor filed for bankruptcy, the rents were not part of the bankruptcy estate as they belonged to the lender.¹²³ In an “additional security” assignment the rents became part of the bankruptcy estate unless the lender had taken the necessary steps to perfect its interest in the rents.¹²⁴

113. *See id.*

114. *Id.*

115. *See id.*

116. *See* CALIFORNIA ASSEMBLY COMM. ON JUD., REPORT ON SB 326, JULY 17, 1991 HEARING, 1991-92 Reg. Sess.

117. *See id.*

118. *See id.*

119. *See id.*

120. *See id.*

121. *See id.*

122. *See id.*

123. *See id.*

124. *See id.*

The California Legislature enacted California Civil Code section 2938 in order to clarify ambiguity surrounding the legal consequences that attached to the different assignment of rents provisions. An examination of the evolution of section 2938 is necessary to understand why the logic used by the *Bugna* court was flawed.

1. Former California Civil Code Sections 2938 and 2938.1

In 1991, the California League of Savings Institutions sponsored California Civil Code section 2938¹²⁵ in response to the increased avoidance of lenders' interest in rents by debtors in bankruptcy court.¹²⁶ While most of these challenges to lenders' interest in rents regarded "additional security" assignments, lenders feared that debtors could apply these same challenges to "absolute" assignments.¹²⁷ The sponsors wanted the legislature to codify the rule that "an 'absolute' or 'additional security' assignment of rents in conjunction with a real property loan is a 'perfected' interest at the time of assignment when that assignment has been executed, delivered and

125. CAL. CIV. CODE § 2938 (West 1993) (repealed 1996). Section 2938, as in effect prior to 1996 legislation, read:

(a) A written assignment of interest in rents, issues, and profits of real property made in connection with a loan secured by real property, stating that it is absolute, shall be deemed to constitute a present transfer of the assignor's interest in existing and future rents, issues, and profits of that real property effective upon the execution and delivery of the assignment by the assignor.

(b) An assignment of an interest in rents, issues, and profits of real property, as described in subdivision (a), may be recorded in the records of the county recorder in which the real property is located in the same manner as any other conveyance of an interest in real property, whether the assignment is in a separate document or part of a mortgage or deed of trust, and when so duly recorded in accordance with the methods, procedures, and requirements for recordation of conveyances of other interests in real property, (1) the assignment shall be deemed to give constructive notice of the content and effect of the assignment with the same force and effect as any other duly recorded conveyance of an interest in real property, and (2) the interest granted by the assignment shall be deemed perfected as of the date of recordation, notwithstanding any provision of the assignment or of any other provision of law that would otherwise preclude or defer enforcement of the rights granted the assignee under the assignment until the occurrence of a subsequent event, including, but not limited to, a subsequent default of the assignor.

Id.; see CALIFORNIA SENATE COMM. ON JUD., REPORT ON SB 326, APR. 9, 1991 HEARING, 1991-92 Reg. Sess.

126. *See id.*

127. *See id.*

recorded."¹²⁸ Following its enactment, section 2938 only codified this rule as applied to "absolute" assignment of rents.¹²⁹

California courts had great difficulty distinguishing between "absolute" and "additional security" assignments.¹³⁰ Courts, in an attempt to make sense out of the disarray, focused on the language of the agreement rather than examining the substance of the agreement.¹³¹ Section 2938 also held form over substance by stating it protected any assignment that used the magic language "absolute" even if the substance of the assignment was for security purposes.¹³² Section 2938 "overrules the long-standing rule that . . . an assignment of future rents made for purposes of security only attaches to rents accruing after the assignee takes affirmative enforcement action. Under the statute, as written, the assignee's lien attaches immediately to all accrued and accruing rents."¹³³ Thus, a literal reading of section 2938 seemed to indicate that as long as lenders included the word "absolute" in the assignment of rents, recordation of the assignment perfected the lenders' interest in the rents.

Lenders whose assignment of rents did not contain the magic word "absolute" were unhappy with this application of section 2938.

Section 2938 does not satisfactorily resolve the difficult problems raised by assignments of rents. Certain of these problems occur because an absolute assignment of rents to a lender is usually intended as an assignment for security. Although the two types of assignment differ in form, in the lending context they usually serve the same function, which is to secure the repayment of indebtedness.¹³⁴

In 1992, California lenders returned to the legislature requesting protection for lenders who received "additional security" instead of "absolute" assignments.¹³⁵ In response the legislature added section

128. *Id.*

129. See Sylvia P. O'Neill, *Assignment of Rents: Mystery or Enigma?*, 10 CAL. REAL PROP. J. 20 (1992).

130. Brian L. Holman, *California Assignments of Rents: A Proposal for a Coherent Methodology of Perfection and Enforceability*, 22 CAL. BANKR. J. 127, 127 (1994). Mr. Holman is a California attorney who specializes in bankruptcy, commercial law and workouts. See *id.* at 127 n.1.

131. See *id.* at 127.

132. See *id.* at 150.

133. *Id.* at 151.

134. O'Neill, *supra* note 129, at 21.

135. See CALIFORNIA ASSEMBLY COMM. ON JUD., REPORT ON SB 1323, JULY 1, 1992 HEARING, 1991-92 Reg. Sess.

2938.1 to the Civil Code.¹³⁶ Section 2938.1 allows lenders who hold an assignment of rents given as additional security to perfect this assignment by recordation.¹³⁷ Therefore lenders need not take possession of the property, appoint a receiver or take any other action to perfect the assignment.¹³⁸

Critics of sections 2938 and 2938.1 argued that the statutes were ambiguous on their face because they failed to provide substantive meaning for the status of being "perfected."¹³⁹ Although the definition of the term "perfection" may be unclear, the relevant legislative history suggests that the "purpose behind both § 2938 and [§ 2938.1 was] to prevent [lenders'] rights to rents from being cut off by a bankruptcy filing."¹⁴⁰

In conclusion, the legislature enacted these statutes for the purpose of "perfecting" lenders' interest in the rents upon recordation, regardless of the form of assignment, and preventing a bankruptcy court from requiring lenders to take some enforcement step after the debtors file a bankruptcy petition.¹⁴¹

136. See CAL. CIV. CODE § 2938.1 (West 1993) (repealed 1996). Section 2938.1, as in effect prior to 1996 legislation, read:

(a) An assignment of the rents, issues, and profits of real property, stating that it is given as additional security, is perfected by the recordation, in the county in which the real property is located, of an instrument granting that assignment. Recordation shall perfect that assignment without the necessity of the beneficiary or mortgagee obtaining possession of the real property, appointing a receiver, or taking any other action.

(b) Notwithstanding subdivision (a), until such time, if any, as the trustor or mortgagor is in default of its obligation to the beneficiary or mortgagee, the beneficiary or mortgagee shall not exercise any rights to collect the rents, issues, and profits.

(c) An assignment as additional security may be contained in a mortgage, deed of trust, or other recorded instrument.

(d) This section shall not invalidate assignments as additional security which have been perfected by other means prior to January 1, 1993, and shall only apply to assignments as additional security which are executed on and after January 1, 1993. This section shall not apply to assignments of rents, issues, and profits of real property which state that they are absolute, as provided in Section 2938.

Id.

137. See O'Neill, *supra* note 129, at 21.

138. See *id.*

139. See Holman, *supra* note 130, at 151.

140. Reynolds, *supra* note 112, at 262.

141. See H. Mark Mersel & Jess R. Bressi, *Lethal Weapon—Recovering Petition Retainers From Debtor's Counsel*, 21 CAL. BANKR. J. 239, 246 (1993).

2. New California Civil Code Section 2938

The California legislature resolved the confusion resulting from sections 2938 and 2938.1 in 1996 when they repealed the statutes and enacted new section 2938.¹⁴² The Assembly Committee on Judiciary stated that former section 2938 provided lenders holding an absolute assignment conditional on default an immediate right to the rents upon the occurrence of some future event, such as, loan default.¹⁴³

The committee acknowledged that judicial interpretation of former section 2938 was inconsistent since one case held that further enforcement was necessary while another case held that the statute did not require any enforcement action.¹⁴⁴ In addition, the committee stated that former section 2938.1 provided that lenders holding an "additional security" assignment could perfect their interest upon recordation, "and relieves the entity entitled to the Rents under the assignment (assignee) from having to foreclose or appoint a receiver in order to perfect the interest."¹⁴⁵ Further, the committee acknowledged that the statute was ambiguous as to what steps were required for lenders to enforce their rights.¹⁴⁶

In 1995, the Real Property Law Section of the State Bar of California sponsored new California Civil Code section 2938 in response to the many unanswered questions that existed under the former statutes.¹⁴⁷ The new statute clarified the steps lenders need to take to secure an interest in the rents at the time lenders create the assignment.¹⁴⁸ It also established the right of borrowers to keep the rents until they default on the loan.¹⁴⁹

The California Bankers Association was also a proponent of new section 2938 and asserted that it was critical "that any question about the enforceability of the 'security' for the loan be resolved by statute in a clear and unambiguous manner. Absent such clarifications, continued commercial financing in this area is at risk."¹⁵⁰

142. See CAL. CIV. CODE § 2938 (West Supp. 1998).

143. See CALIFORNIA ASSEMBLY COMM. ON JUD., REPORT ON SB 947, MAR. 27, 1996 HEARING, 1995-96 Reg. Sess. [hereinafter MARCH REPORT ON SB 947].

144. See *id.* Compare *In re GOCO Realty Fund I*, 151 B.R. 241 (Bankr. N.D. Cal. 1993), and *MDFC Loan Corp. v. Greenbrier Plaza Partners*, 21 Cal. App. 4th 1045, 26 Cal. Rptr. 2d 596 (1994).

145. MARCH REPORT ON SB 947, *supra* note 143.

146. See *id.*

147. See *id.*

148. See *id.*

149. See *id.*

150. *Id.*

New section 2938 reconciled the ambiguities that existed in former sections 2938 and 2938.1.¹⁵¹ Specifically, section 2938(c):

States that, upon the default of the borrower (assignor), the assignee is entitled to collect and receive all of any Rents that have accrued but are unpaid and uncollected or that will accrue if the assignee either: a) has a receiver appointed; b) obtains possession of the Rents; c) delivers a written demand (as specified) for the Rents to one or more of the tenants; or d) delivers a written demand for the Rents to the assignor.¹⁵²

New section 2938 only applies to contracts entered into on or after January 1, 1997.¹⁵³

By enacting former sections 2938 and 2938.1, the California legislature moved away from the requirement of an enforcement step. The legislature enacting these sections properly wanted to protect lenders' interest in the rents by providing lenders a present possessory interest in the rents as soon as lenders record the assignment of rents. Therefore, the enactment of new section 2938 and the court's decision in *Bugna* is unmistakably a step backward in the evolution of California real property law because it strips lenders of this protection.

B. Federal Legislative History

In light of the rapid progress of reform in the state legislatures, Congress decided to address lenders' concerns and solved the issue in 1994. During the late 1980's and early 1990's, debtors filed a proliferation of bankruptcy cases as a result of declining real estate values.¹⁵⁴ Lenders were critical of this trend as they perceived the Chapter 11 bankruptcy process to be too debtor-oriented.¹⁵⁵ Debtors' unreasonable delays in the reorganization process as well as debtors' unrestricted use of the rents during bankruptcy frustrated lenders.¹⁵⁶

151. *See id.*

152. *Id.*

153. *See* CAL. CIV. CODE § 2938(i) (West Supp. 1998). "Sections 2938 and 2938.1, as these sections were in effect prior to *January 1, 1997*, shall govern contracts entered into *prior to January 1, 1997*, and shall govern actions and proceedings initiated on the basis of these contracts." *Id.*

154. *See* Eugene A. Pinover & Marc Abrams, *Bankruptcy Amendments: BAA Expected to Level the Playing Field in Real Estate Cases*, N.Y. L.J., Jan. 19, 1994, at 5, 5.

155. *See id.*

156. *See id.*

The Bankruptcy Reform Act of 1994¹⁵⁷ ("Reform Act") was "designed to level the playing field and alleviate these perceived abuses of the bankruptcy process."¹⁵⁸ As a result, a number of provisions in the Reform Act had an important impact on the rights of commercially secured lenders.¹⁵⁹ Congress enacted these new provisions in order to provide clarity to existing case law and corresponding state law.¹⁶⁰

Senator Hatch expressed the importance of the Reform Act:

Mr. President, the Bankruptcy Act of 1994 is one of the most important pieces of economic legislation to be considered and passed by the 103d Congress. It is important because it clarifies many of the existing ambiguities in our bankruptcy law that have, in essence, discouraged the extension of new credit to our businesses in Utah and throughout the Nation.

The bill responds to these concerns by offering clear guidance to both creditors and debtors as to the risks they are undertaking. It strikes a fair and delicate balance between the rights and responsibilities of creditors and the rights and obligations of debtors. More importantly, it encourages the credit community to extend much needed new capital to the well deserving businesses in our communities seeking to grow and expand. In sum, this bill is good for business, good for creditors and good for consumers.¹⁶¹

Specifically, the Reform Act introduced a provision that would provide a more balanced and ameliorative approach to determining whether a lender has an interest in post-petition rents by amending § 552(b).¹⁶²

1. Legislative interpretation of the Reform Act's amendment of 11 U.S.C. § 552(b)

The Reform Act revised § 552 of the Bankruptcy Code titled "Postpetition effect of security interest."¹⁶³ The adverse effect of

157. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4150 (codified as amended in scattered sections of 11 U.S.C.).

158. Pinover & Abrams, *supra* note 154, at 5.

159. See Heidt, *supra* note 96, at 395.

160. See *id.*

161. 140 CONG. REC. S14,464 (daily ed. Oct. 6, 1994) (statement of Sen. Hatch).

162. See Pinover & Abrams, *supra* note 154, at 6.

163. 11 U.S.C. § 552 (1994) (amending 11 U.S.C. § 552 (1978)). In both the House and Senate this amendment was titled "protection of security interest in

Butner on secured parties concerned the drafters of the Reform Act because "a secured party's right to rents generated by the collateral depended on whether the secured party was entitled to the rents under state law."¹⁶⁴

A recurring problem in bankruptcy proceedings was whether the lender perfected its interest in the rents before the debtor filed the bankruptcy petition. As noted above, the various states did not agree when lenders perfect an interest in rents. This disagreement caused inconsistencies in the court system. The purpose of the amendment to § 552 was to provide lenders with consistent results regardless of the variations that occurred within each state's law.¹⁶⁵ Amended § 552(b)(2) reads as follows:

(2) Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, 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 the fees, charges, accounts, 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 to the extent provided in such security agreement, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.¹⁶⁶

Philip S. Corwin, serving as Director and Counsel of the American Bankers Association, testified in front of the Subcommittee on Economic and Commercial Law regarding bankruptcy reform.¹⁶⁷ As part of his testimony, Mr. Corwin analyzed the effect that an amendment to § 552 would have on commercial lenders.¹⁶⁸ Mr. Corwin

postpetition rents." 140 CONG. REC. H10,768 (daily ed. Oct. 4, 1994) (section-by-section description of Bankruptcy Reform Act of 1994).

164. See Heidt, *supra* note 96, at 396.

165. See *id.* at 399-400.

166. 11 U.S.C. § 552(b)(2)(1994).

167. See *Bankruptcy Reform: Hearing Before the Subcomm. on Econ. and Commercial Law*, 103rd Cong. 191 (1994) (statement of Philip S. Corwin, Director & Counsel, Operations and Retail Banking, American Bankers Association). "American Bankers Association is the national trade and professional association for America's commercial banks . . ." *Id.*

168. See *id.* at 191-92.

stated that banks acting as real estate lenders faced significant difficulties under current bankruptcy practices.¹⁶⁹

He illustrated this point to the subcommittee with the following scenario that is all too familiar to commercial lenders. If a real estate developer defaults on a loan, the lender will institute a foreclosure action, a lengthy process that may take up to one year before completion.¹⁷⁰ In order to avoid the foreclosure, the debtor will file a Chapter 11 bankruptcy petition which prevents the lender from pursuing the foreclosure action due to the automatic stay.¹⁷¹ The court then allows the debtor 120 days to file a plan of reorganization, and often the court is willing to extend this filing period.¹⁷² As time passes, the debtor continues to collect the rents and to use them for his own purpose, such as paying his attorney's fees or using them for his own personal benefit.¹⁷³ Chances are, the debtor has not used the rents to maintain the property or pay taxes and insurance.¹⁷⁴

The bankruptcy court seldom confirms the Chapter 11 plan, because the debtor does not have enough capital to make it feasible.¹⁷⁵ So, at the end of this wearisome process, the lender will take possession of the potentially rundown property knowing that the rents received during this process are unavailable to rehabilitate the property.¹⁷⁶

Mr. Corwin believed that debtors in this typical scenario abused the bankruptcy process and that the legislature needed to address this abuse.¹⁷⁷ For this reason, Mr. Corwin supported the revision of § 552. "[American Bankers Association] believes that the severity of the difficulties currently facing mortgage lenders on loans already outstanding, and the growing abuse of single asset reorganizations by real estate developers, suggests that a remedial federal statute would be the most expeditious and effective means for addressing this problem."¹⁷⁸

169. *See id.* at 211.

170. *See id.*

171. *See id.*

172. *See id.*

173. *See id.*

174. *See id.*

175. *See id.*

176. *See id.*

177. *See id.*

178. *Id.* at 212.

Essentially, new § 552(2)(b) gives lenders the benefit of automatic perfection once debtors file the bankruptcy petition.¹⁷⁹ Therefore, after new § 552 bankruptcy courts treat lenders uniformly, regardless of the requirements that may exist under state law.¹⁸⁰

Some critics argue that the statutory language does not provide this plain meaning and state that it may provide the opposite meaning.¹⁸¹ The legislative history of the statute, however, supports the pro-lender interpretation.¹⁸² "According to Congressman Jack Brooks, the amendment to § 552(b) 'provides that lenders may have valid security interests in postpetition rents for bankruptcy purposes notwithstanding their failure to have fully perfected their security interest under applicable State law.'"¹⁸³

The participants at several hearings regarding the amendment to § 552(b) clearly understood the meaning of the statutory language. The National Bankruptcy Conference ("NBC") presented a detailed statement of its position on Senate Bill 540 at a hearing before the Subcommittee on Court and Administrative Practice to discuss the protection of security interests in post-petition rents.¹⁸⁴ It was the NBC's understanding that:

As drafted, proposed Section 552(b)(2) would give a secured creditor an interest in postpetition rents as long as the security agreement was duly recorded in public records, whether or not the security interest is perfected as a matter of applicable nonbankruptcy law.

. . . Thus, [proposed Section 552(b)(2)] would give a secured creditor with an interest in these items more rights under the Bankruptcy Code than they might enjoy under applicable nonbankruptcy law.¹⁸⁵

179. See Heidt, *supra* note 96, at 400.

180. See *id.* In amending the Bankruptcy Code, Congress nullified the United States Supreme Court's concern in *Butner* that a uniform federal standard would lead to forum shopping. The concern for lenders' rights and the ambiguity of state statutes and courts' interpretations of those statutes outweighed this concern of forum shopping.

181. See David Gray Carlson, *Rents in Bankruptcy*, 46 S.C. L. REV. 1075, 1085-86 (1995).

182. See *id.* at 1085.

183. *Id.* (quoting 140 CONG. REC. H10,768 (daily ed. Oct. 4, 1994) (statement of Rep. Brooks)).

184. See *The Bankruptcy Amendments Act of 1993: Hearing on S. 540 Before the Subcomm. on Courts and Admin. Practice*, 103rd Cong. 102 (1993) (statement of the National Bankruptcy Conference).

185. *Id.* at 128-29 (statement of the National Bankruptcy Conference).

William J. Perlstein who testified on behalf of the American Bankruptcy Institute at this same hearing also shared this interpretation of proposed § 552(b)(2).¹⁸⁶ “The bill clarifies that, so long as the creditor had a duly recorded security interest, it is not necessary to have perfected that security interest, such as by having had a receiver appointed, in order for the security interest to apply to postpetition rents.”¹⁸⁷

Finally, Edward Miller testified on behalf of the American Council of Life Insurance (“ACLI”).¹⁸⁸ Mr. Miller acknowledged that often times a debtor will take advantage of the bankruptcy system by filing under Chapter 11 right before a creditor can exercise its assignment of rents under state law.¹⁸⁹ The debtor does this to prevent the creditor from enforcing its interest in the rents during the bankruptcy proceeding.¹⁹⁰ Mr. Miller stated that proposed § 552(b)(2) “simply precludes the debtor from ignoring a creditor’s bargained for interest in the rents and squandering them during the Chapter 11 case.”¹⁹¹

Mr. Miller set forth several policy reasons for ACLI’s support of this proposed section. First, there will be a substantial amount of savings in both time and expense because this provision creates more certainty for both the creditor and the debtor.¹⁹² Thus, this will make more money available for capital investments.¹⁹³ In addition, debtors will not institute so many bankruptcy filings if they know their plan does not have a reasonable chance of confirmation, and therefore, the bankruptcy system will become more efficient.¹⁹⁴

Most importantly, the House of Representatives and Senate interpreted proposed § 552(b)(2) consistently with those who testified

186. *See id.* at 162, 174 (statement of William J. Perlstein, American Bankruptcy Institute).

187. *Id.* at 174 (statement of William J. Perlstein, American Bankruptcy Institute).

188. *See id.* at 354 (statement of Edward Miller, American Council of Life Insurance).

189. *See id.* at 355 (statement of Edward Miller, American Council of Life Insurance).

190. *See id.* (statement of Edward Miller, American Council of Life Insurance).

191. *Id.* (statement of Edward Miller, American Council of Life Insurance).

192. *See id.* at 356 (statement of Edward Miller, American Council of Life Insurance).

193. *See id.* (statement of Edward Miller, American Council of Life Insurance).

194. *See id.* (statement of Edward Miller, American Council of Life Insurance).

above. The House initially issued a report on these proposed amendments on October 3, 1992.¹⁹⁵ At this time, the House had a clear understanding of the issues involved with the protection of a security interest in rents. It recognized that, in a number of states, real estate lenders were unable to perfect their security interests in the rents before a bankruptcy filing.¹⁹⁶ The initial House Report and a subsequent House Report both acknowledged that the proposed bill "provides that lenders may have valid security interests in post-petition rents for bankruptcy purposes notwithstanding their failure to have fully perfected their security interest under applicable State law."¹⁹⁷

2. Academics and practicing attorneys' interpretation of the Reform Act's amendment of 11 U.S.C. § 552(b)

Not only did Congress understand the impact of this revision to the Bankruptcy Code, academics and practicing attorneys also understood the implications. In the treatise titled *Norton Bankruptcy Law and Practice*, the author recognized that the only time that the court should look to state law to determine whether the lender took appropriate enforcement actions to perfect his security interest in rents is if the case had commenced prior to October 22, 1994, the effective date of the Bankruptcy Reform Act of 1994.¹⁹⁸

In a Practice Law Institute ("PLI") publication, Mr. Jeff Bohm and Mr. David B. Young, both attorneys, argued that when Congress created § 552(b)(2) it clearly overturned *Butner* and created a uniform national system for protecting lenders' rights to the assignment of rents in bankruptcy.¹⁹⁹ The PLI authors illustrated this conclusion by pointing to a recent bankruptcy court opinion which stated that "[s]ection 552(b)(2) offers a compelling example of congressional intent not to let states decide freely what shall be property of the

195. See H.R. REP. NO. 102-996, at 23 (1992).

196. See *id.*

197. *Id.*; see also H.R. REP. NO. 103-835, at 49 (1994), reprinted in 1994 U.S.C.C.A.N. 3340 (same language used as in initial House Report).

198. See 2 WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW AND PRACTICE 2D § 37:5, at 98 (2d ed. Supp. 1997).

199. See Jeff Bohm & David B. Young, *Small Business and Single Asset Real Estate Reorganizations and the Bankruptcy Reform Act of 1994*, in 2 19TH ANNUAL CURRENT DEVELOPMENTS IN BANKRUPTCY AND REORGANIZATION 465, 527 (PLI Commercial Law & Practice Course Handbook Series No. A-753, 1997).

debtor."²⁰⁰ Therefore, § 552(b)(2) clarified lenders' rights to post-petition rents.²⁰¹

The PLI authors acknowledge that the assignment of rents are subject to the bankruptcy estate's long-arm avoidance powers.²⁰² Critics therefore argued that if state law requires lenders to take an enforcement step post-default, such as securing a receiver, and lenders failed to do so, then state law leaves lenders with an unperfected interest in the rents.²⁰³ The authors strongly asserted that "such an interpretation would violate every canon of statutory construction. This type of argument would render 11 U.S.C. § 552(b)(2) self-nullifying and meaningless, and it would frustrate the obvious intent of Congress."²⁰⁴ A reasonable interpretation of § 552(b)(2) is that an assignment of rents is a valid lien in bankruptcy as long as lenders record the assignment pre-petition.²⁰⁵

Additionally, Mr. H. Mark Mersel and Mr. Jess R. Bressi, specialists in bankruptcy law, corporate reorganizations and business litigation, state that § 552 "provides, *inter alia*, that the security interest resulting from a security agreement which encumbers rents . . . and which is duly recorded prepetition, extends to all postpetition rents and income without requiring the secured creditor to take any further 'perfection' action."²⁰⁶

3. Judicial interpretation of the Reform Act's amendment of 11 U.S.C. § 552(b)

In the case *In re Fairview-Takoma Ltd. Partnership*,²⁰⁷ the same issue faced the Bankruptcy Court for the District of Maryland as faced the California State court in *Bugna*. Fairview Takoma Limited Partnership ("Fairview"), the debtor, owned a residential apartment complex.²⁰⁸ When Fairview purchased the property, it executed an assignment of rents in favor of the lender.²⁰⁹ The recordation of the assignment of rents occurred a few days later in the Land Records of

200. *Id.* at 527-28 (quoting *In re County of Orange*, 191 B.R. 1005, 1018 (Bankr. C.D. Cal. 1996)).

201. *See id.* at 529.

202. *See id.*

203. *See id.*

204. *Id.* at 529-30.

205. *See id.* at 531.

206. Mersel & Bressi, *supra* note 141, at 239 n.1 & 240 n.4.

207. 206 B.R. 792 (Bankr. Md. 1997).

208. *See id.* at 795.

209. *See id.*

Prince George's County, Maryland.²¹⁰ As a result of subsequent transfers among lenders, Condor One, Inc. ("Condor") became the mortgagee and holder of the assignment.²¹¹

On September 26, 1996, Condor hand delivered a letter to Fairview notifying Fairview that it had defaulted on the loan.²¹² Fairview did not come current on the loan, therefore, on September 27, 1996, Condor filed suit in state court and requested the immediate appointment of a receiver.²¹³ On the afternoon of September 27, 1996, Fairview filed a Chapter 11 petition in bankruptcy court.²¹⁴ As a result, the court stayed Condor's request for the appointment of a receiver.²¹⁵

Fairview then requested that the bankruptcy court allow it to use the rents generated by the property.²¹⁶ Condor argued that it held a lien interest in the rents as a result of the assignment of rents executed by Fairview and recorded by the lender, and therefore, the rents were cash collateral.²¹⁷ Fairview disputed Condor's claim, stating that Condor failed to provide it with proper notice of default, as required by the loan documents, before Fairview filed its bankruptcy petition.²¹⁸ As a result, Fairview asserted that it had the right to use the rents as it saw fit in the ordinary course of its business.²¹⁹

Judge Keir believed the main issue in the dispute between Fairview and Condor was whether Condor held an interest in the rents under § 363(a) of the Bankruptcy Code.²²⁰ "Thus the Rents are cash collateral to the extent that both Condor and Fairview's bankruptcy estate hold an interest in the Rents, and to the extent that the Rents are subject to a security interest as provided in § 552(b) of the Bankruptcy Code."²²¹

The court gave three alternate reasons for concluding that Condor held a security interest in the post-petition rents.²²² First, the court found that the loan documents clearly conveyed an interest in

210. *See id.*

211. *See id.*

212. *See id.*

213. *See id.*

214. *See id.*

215. *See id.*

216. *See id.*

217. *See id.*

218. *See id.*

219. *See id.*

220. *See id.* at 796.

221. *See id.*

222. *See id.* at 797.

the rents to Condor.²²³ Second, the court concluded that pursuant to a Maryland statute that deals specifically with the issue raised in this case, the perfection of Condor's security interest in the rents occurred at the time of recordation.²²⁴ Finally, the court stated that regardless of state law, § 552(b)(2) of the Bankruptcy Code, as added by the Bankruptcy Reform Act of 1994, mandates the same result; that Condor had a security interest in the post-petition rents.²²⁵

Judge Keir acknowledged that while uncertainty among various jurisdictions existed as to the appropriate test for determining whether a lender had an interest in the rents, the Maryland legislature and Congress resolved the conflict.²²⁶ Congress amended the Bankruptcy Code in the Bankruptcy Reform Act of 1994 "in order to eliminate this uncertainty and clarify the appropriate treatment of a security interest in rents subsequent to the commencement of a bankruptcy case by a mortgagor."²²⁷

The bankruptcy court acknowledged that, in amending the Bankruptcy Code, Congress nullified the United States Supreme Court's decision in *Butner*.²²⁸ *Butner* held that state law governed when determining "the validity and extent of a mortgagee's interest in the assets of a bankruptcy estate, including an interest in rents generated by the mortgaged property."²²⁹

Judge Keir analyzed the legislative intent of the amendment to § 552(b)(2) and quoted an explicit statement of purpose from the House Report accompanying the Bankruptcy Reform Act of 1994.²³⁰ "Section 214 [of the Act] provides that lenders may have valid security interests in post-petition rents for bankruptcy purposes notwithstanding their failure to have fully perfected their security interest under applicable State law."²³¹ As a result, § 552(b)(2) eliminates the necessity to analyze state law to determine whether Condor perfected its interest in the rents for purposes of § 363(a).²³²

Apparently, lobbyists, senators, representatives, and academics clearly understood the intent behind the amendment to § 552 in the

223. *See id.*

224. *See id.*

225. *See id.*

226. *See id.* at 800.

227. *Id.*

228. *See id.*

229. *Id.*

230. *See id.* at 801.

231. *Id.* (quoting H.R. REP. NO. 103-835, at 48-49 (1994)).

232. *See id.*

Reform Act. It is also clear that the bankruptcy court has a clear understanding of the legislative intent behind this amendment.

VI. AN ISSUE OF STATUTORY INTERPRETATION: WHY *BUGNA* WAS WRONG

Determining whether FNMA had a present possessory interest in post-default rents depended on whether it qualified under the "perfected" language of former California Civil Code section 2938 and, due to the preemption of federal law on this issue, 11 U.S.C. § 552(b)(2). Obviously, this is a matter of statutory interpretation.

The United States Supreme Court established that courts should interpret statutes to achieve their legislative intent.²³³ California courts have also recognized that a literal construction of a statute may be inappropriate when the result clearly contradicts the apparent legislative intent.²³⁴ Moreover, the California Supreme Court ruled that when a court could determine the legislative intent, "a statute must be liberally construed to effectuate that intent."²³⁵

The *Bugna* court's interpretation of former section 2938 failed to achieve the legislature's intent of expanding protection to lenders. In addition, the *Bugna* court failed to interpret and apply 11 U.S.C. § 552(b)(2) which preempted the court's discussion of state law.

A. *Bugna* Incorrectly Interpreted State Law

First, the *Bugna* court stated that the terms of the assignment of rents clause in the trust deed expressly required FNMA to provide Bugna with written notice of default and demand for rents.²³⁶ Thus, the trust deed only entitled FNMA to the rents collected post-default after it gave Bugna a written demand. If the court had limited its reasoning to a contractual interpretation of the trust deed the opinion

233. See Neil D. Okazaki, Note, *People v. Sexton: Insuring an Absurd Result Through Inflexible Interpretation—The Court of Appeal Denies Criminal Restitution to a Victim's Insurance Company*, 31 LOY. L.A. L. REV. 297, 313 & n.126 (1997). See e.g., *Philbrook v. Glodgett*, 421 U.S. 707, 713 (1975) (stating that courts are to ascertain congressional intent and follow legislative will); *United States v. American Trucking Ass'ns*, 310 U.S. 534, 542 (1940) (stating that courts must interpret statutes so as to give effect to congressional intent).

234. See Okazaki, *supra* note 233, at 313-14.

235. *Id.* at 314 (citing *In re Haines*, 195 Cal. 605, 613, 234 P. 886, 886 (1925)).

236. See *Federal Nat'l Mortgage Ass'n v. Bugna*, 57 Cal. App. 4th 529, 536, 67 Cal. Rptr. 2d 233, 237 (1997).

would be upsetting to lenders but doctrinally defensible.²³⁷ Lenders could have remedied the problem by reworking the language contained in their trust deeds.²³⁸

Unfortunately for lenders, the *Bugna* court relied extensively on *GOCO Realty*, a bankruptcy court opinion that narrowly construed former California Civil Code section 2938.²³⁹ The *GOCO Realty* court held that former section 2938 allowed the borrower to continue collecting the rents post-default until the lender took an enforcement step.²⁴⁰

FNMA argued that the purpose behind the legislature's enactment of former section 2938 was to eliminate the requirement of an enforcement step.²⁴¹ As support, FNMA relied on the California court of appeal's opinion in *MDFC* that held that former section 2938 eliminated the need for lenders to take an enforcement step.²⁴² The *Bugna* court responded by distinguishing *MDFC* on its facts.²⁴³ In addition, the *Bugna* court argued that the initial draft of former section 2938 was consistent with FNMA's interpretation, however, opponents criticized the initial draft.²⁴⁴ The drafters reworded the statute after this criticism so the court concluded that the final version of former section 2938 still required an enforcement step by the lender.²⁴⁵

Assuming the *Bugna* court was correct in relying on former section 2938 to determine the validity of FNMA's security interest in the rents, the issue is whether the court's interpretation of former section 2938 was consistent with the legislative intent.

Even if FNMA conceded that former section 2938 was ambiguous on its face as to whether an enforcement step is necessary, the legislative history supported FNMA's assertion that the statute eliminated the requirement of an enforcement step. Lenders introduced former section 2938 to stop debtors in bankruptcy from

237. See Memorandum from Dan S. Schechter, Professor of Law, Loyola Law School, Los Angeles, *Federal National Mortgage Association v. Bugna*, 1997 *Westlaw* 531085 (1997), (Sept. 1997) (on file with author).

238. See *id.*

239. See CAL. CIV. CODE. § 2938 (West 1993) (repealed 1996); *GOCO Realty*, 171 B.R. 241, 241 (Bankr. N.D. Cal. 1993).

240. See *GOCO Realty*, 171 B.R. at 248.

241. See *Bugna*, 57 Cal. App. 4th at 539, 67 Cal. Rptr. 2d at 239.

242. See *id.* at 540, 67 Cal. Rptr. 2d at 240.

243. See *id.*

244. See *id.* at 539-40, 67 Cal. Rptr. 2d at 239-40.

245. See *id.* at 540, 67 Cal. Rptr. 2d at 240.

avoiding lenders' interests in an "absolute" assignment of rents.²⁴⁶ The legislature later extended this protection to "additional security" assignments when it enacted former section 2938.1.²⁴⁷

The *Bugna* court was incorrect when it held that the amendment to the initial draft of former section 2938 changed the statute's meaning. If the court's conclusion was correct then the redrafting completely nullified the original purpose of the statute, a conclusion that defies logic. Furthermore, subsequent legislative hearing directly addressed this issue.

In 1996 the California legislature acknowledged that sections 2938 and 2938.1 were confusing and in response it repealed both of the statutes and enacted new section 2938.²⁴⁸ Nonetheless, the Assembly Committee on Judiciary acknowledged that despite the inconsistent judicial interpretation of the former statutes, the former statutes provided that a lender holding an assignment of rents perfected its interest in the rents upon recordation.²⁴⁹ In other words, a lender did not need to take an enforcement step because a lender holds an immediate right to the rents upon default.

The *Bugna* court's interpretation of former sections 2938 and 2938.1 was clearly erroneous and as such the court should have transferred all the rents collected post-default to FNMA.

In the future, however, new section 2938 should concern lenders as it affects transactions created after January 1, 1997. New section 2938 eliminated any ambiguities that existed in prior statutes by definitively stating that an assignment of rents does not entitle lenders to rents collected after default but before demand. The new statute further describes acceptable methods by which a lender can make a demand. This statute creates a heavy burden on lenders to carefully monitor borrowers, when a default occurs the lender must declare a default and make a written demand for rents.

The real problem for lenders arises under the following scenario: When the debtor defaults and then immediately files for bankruptcy. In this scenario the lender does not have a chance to take an

246. See CALIFORNIA SENATE COMM. ON JUD., REPORT OF SB 326, APR. 9, 1991 HEARING, 1991-92 Reg. Sess.

247. CAL. CIV. CODE § 2938.1 (West 1993) (repealed 1996).

248. See CAL. CIV. CODE § 2938 (West Supp. 1998).

249. MARCH REPORT ON SB 947, *supra* note 143.

“enforcement step” before the bankruptcy filing.²⁵⁰ During the bankruptcy the rents are still collected.²⁵¹ Under new section 2938 the lender is not entitled to the rents.²⁵² Lenders must now look to the Bankruptcy Code to determine whether they are entitled to rents collected post-petition.

B. Bugna Failed to Apply Applicable Federal Law

In the above discussion this Note assumed, for purposes of analysis, that the *Bugna* court was correct in applying California law to determine whether the assignment of rents provision in the trust deed entitled FNMA to post-default rents. Now, this Note will discard this assumption and address whether the *Bugna* court’s application of California law was correct. This issue is relevant because in *Bugna* the receiver obtained the rents in controversy during the bankruptcy proceeding. It is possible that the Bankruptcy Code required *Bugna* to preempt its application of California law with an application of relevant bankruptcy law.

As evidenced by the above discussion, uncertainty existed in state law as to when an assignment entitled lenders to the rents. Lenders frustrated with the inconsistencies that occurred as a result of this uncertainty requested that Congress amend § 552 to provide lenders with a consistent result regardless of the variations that occurred within each state’s law.

In response, Congress passed the Reform Act which amended § 552. Section 552(b)(2) now states that if a lender recorded the assignment of rents before default, the lender has a valid security interest in the post-petition rents regardless of whether it met the enforcement requirements under state law. In other words, as long as FNMA recorded the trust deed, FNMA had a valid security interest in the rents collected post-petition even if FNMA did not meet the perfection requirements as established by former California Civil Code § 2938.

Essentially, amended § 552(b)(2) overrules *Butner*, which states that bankruptcy courts should look to state law to determine the validity of a lender’s security interest in the rents, and instead creates a uniform federal rule regarding assignment of rents. The bankruptcy court in *Fairview* understood perfectly the implications of this

250. See Memorandum from Dan S. Schechter, *supra* note 250.

251. See *id.*

252. See *id.*

amendment and held that § 552(b)(2) eliminates the necessity to analyze state law to determine whether the lender perfected its interest in the rents.

VII. PROPOSED SOLUTION FOR LENDERS

Regardless of the clarity that § 552(b)(2) brings to the analysis of lenders' security interest in the assignment of rents, courts will most likely continue to fail to apply the statute as intended. In order to avoid costly litigation lenders in California will need to find creative solutions to the problem.

One solution is for the lender to have control of the cash flow from the property by requiring the borrower enter into a lock box or blocked account system.²⁵³ In a lock box arrangement the tenants send their rent payments to a specified post office box.²⁵⁴ A local bank takes the payments from the post office box and deposits them in accounts with that bank.²⁵⁵ The bank then agrees to transfer these funds to the lender's account on a daily basis.²⁵⁶

A blocked account system allows the borrower to collect payments from the tenants but it must deposit these payments into a bank account under the control of the lender.²⁵⁷ The lender monitors the account daily to make sure the expected deposits are being made.²⁵⁸

Under a lock box or blocked account system the lender always reserves the right to notify the tenants to make payment directly to the lender.²⁵⁹ Depending on the cash flow from the property the payments are first applied to the debt and then apportioned to the borrower for payment of normal operating expenses.²⁶⁰

In order to survive bankruptcy, the arrangement should include

253. See Marsha E. Simms, *Introduction to Secured Lending and Commercial Finance*, in ASSET-BASED FINANCING 19, 41 (PLI Commercial Law & Practice Course Handbook Series No. A-739, 1996).

254. See *id.*

255. See *id.*

256. See *id.*

257. See *id.*

258. See *id.*

259. See *id.*

260. See Craig H. Averch et al., *Bankruptcy Issues: Emphasizing Drafting Considerations in Protecting Against Insolvency (Including Selected Issues in Single Asset Real Estate Bankruptcies)*, C950 A.L.I.-A.B.A. 303, 331 (1994).

a provision that states it is effective on a post-petition basis.²⁶¹ Furthermore, the lender should include the terms of a cash collateral order in the arrangement.²⁶² Finally, the borrower should execute an acknowledgment stating that the lender has a perfected lien on the rents from the property.²⁶³

VIII. CONCLUSION

The Reform Act revolutionized creditors' rights with respect to assignment of rents. The Reform Act ended the federal bankruptcy courts confusing attempts to interpret often contradictory state assignment of rents laws. Instead, it created a uniform rule of law whereby a lender who holds an assignment of rents has a valid present possessory interest in post-petition rents regardless of whether the lender perfected the interest as required by state law.

*Joanne N. Davies**

261. *See id.*

262. *See id.*

263. *See id.*

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