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Rents in Bankruptcy

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I. THE STRUGGLE OVER CASH FLOW

Upon first impression, proceeds of real estate—rents—would appear to be personal property. These proceeds are initially general intangibles or rent receivables. Once collected, they are money, checks, or bank

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accounts—exemplars of *personal* property. Furthermore, rights under a lease were classically considered mere contractual rights and were a form of personal property—"chattels real," to use the ancient phrase.[1]

In many states, the chattel real has been rechristened a real property interest.[2] Even in states where leaseholds are still chattels, Article 9 of the Uniform Commercial Code (U.C.C.) excludes security interests on real estate receivables from its coverage in section 9-104(j), which provides: "This Article does not apply . . . (j) to the creation or transfer of an interest in or lien on real estate, *including a lease or rents thereunder* . . . ."[3] Thus, it is impossible to claim that Article 9 applies to security interests in rent receivables.[4]

Prior to "severance" from the real property through collection,[5] rent receivables may have been encumbered by a mortgage lien. For that reason, real property law has jurisdiction over security interests on real estate receivables. In this respect, rents are like lumber or crops—real property that becomes personal property through severance. These too can be encumbered by mortgage liens before they become personal property.[6]

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1. On this ancient status of the leasehold as personal property, see R. Wilson Freyermuth, *Of Hotel Revenues, Rents, and Formalism in the Bankruptcy Courts: Implications for Reforming Commercial Real Estate Finance*, 40 UCLA L. REV. 1461, 1478-81 (1993).

2. *E.g.*, N.Y. Civ. Prac. L. & R. 105(s) (McKinney 1990).

3. U.C.C. § 9-104(j), 3 U.L.A. 179 (1990) (emphasis added).

4. *In re* Bristol Assocs., 505 F.2d 1056 (3d Cir. 1974) (Adams, J.) (ruling that Article 9 does not apply to the assignment of rents). A different problem beyond the scope of this Article is whether hotel receivables are proceeds of real estate or whether they are pure accounts receivable to which Article 9 applies. *See generally* Freyermuth, *supra* note 1. As part of the Bankruptcy Reform Act of 1994, Congress recently enacted § 552(b)(2) to establish that hotel receipts are to be treated as real estate receivables, thereby preempting state law on the question. 11 U.S.C.A. § 552(b)(2) (West Supp. 1995).

5. Collection of rent by the debtor is sometimes called the severance of the rents from the underlying real property. *See* Julia P. Forrester, *A Uniform and More Rational Approach to Rents as Security for the Mortgage Loan*, 46 RUTGERS L. REV. 349, 358 (1993).

6. Professor Forrester, who advocates that § 9-104(j) be amended so that Article 9 might cover security interests on rent receivables, complains that the U.C.C. covers crops, and yet, before they are severed, crops are just as likely to be encumbered by a mortgage lien. Accordingly, there is no good reason why rent receivables should not fall within the provisions of Article 9 as well. *See* Forrester, *supra* note 5, at 409-11, In particular, Article 9 coverage would allow for the separate use of receivables as collateral where the security interest does not reach the debtor's reversionary interest in real estate. *See id.* at 415; *see also In re* Claremont Towers Co., 175 B.R. 157, 166 (Bankr. D.N.J. 1994) (Gindin, J.) (alleging that a security interest in rents can exist independently from a mortgage on the real estate); Craig H. Averch, *Revisitation of the Fifth Circuit Opinions of Village Properties and Casbeer: Is Post-Petition "Perfection" of an Assignment of Rents Necessary to Characterize Rental Income as Cash Collateral?*, 93 COM. L.J. 516, 526-27 (1988) (asserting that Texas law already provides for this possibility).

The mortgage lien on rent receivables is an important concept in single-asset real estate bankruptcies—the most common Chapter 11 case in the early 1990s.[7] At stake is the ownership and control of cash flow. A valid security interest on rent receivables establishes that the secured party owns the cash flow. An invalid security interest on rent receivables establishes that the debtor owns the cash flow.

All possible positions have been taken on the question of who owns the cash flow. The fate of security interests on rent receivables has ranged from total avoidance on a strong-arm theory[8] to the remarkable view that a

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There is a movement afoot to bring rent receivables directly under Article 9 of the U.C.C., thereby ending any distinction between real property proceeds and personal property proceeds. *See* Forrester, *supra* note 5; Freyermuth, *supra* note 1, at 1536-41; Alexander Rostocki, Jr., *Perfecting Security Interests in Rents: Article 9 Must be Amended*, 24 U.C.C. L.J. 151 (1991); Comment, *An Article Nine Scope Problem—Mortgages, Leases, and Rents as Collateral*, 47 U. COLO. L. REV. 449, 459-60 (1976).

7. In the early 1990s, these single-asset cases constituted about half of the Chapter 11 docket of a typical bankruptcy judge. *Good Faith: A Roundtable Discussion*, 1 AM. BANKR. INST. L. REV. 11, 15-16 (1993) (remarks of Judges Fenning, Greendyke, Hillman, and Mark). A great many of the most intractable problems in bankruptcy law are generated by the single-asset bankruptcy, including the classification veto, the bad faith Chapter 11 filing, the new value exception to the absolute priority rule, and the confusing effect that adequate protection payments have on the undersecured claim of a real estate financier. *See generally* John D. Ayer, *Bankruptcy as an Essentially Contested Concept: The Case of the One-Asset Case*, 44 S.C. L. REV. 863 (1993); David Gray Carlson, *Adequate Protection Payments and Surrenders of Cash Collateral in Chapter 11 Cases*, 14 CARDOZO L. REV. 1387 (1994) [hereafter cited as Carlson, *Adequate Protection Payments*]; David Gray Carlson, *The Classification Veto in Single Asset Cases Under Bankruptcy Code Section 1129(a)(10)*, 44 S.C. L. REV. 565 (1993) [hereafter cited as Carlson, *Classification Veto*]; Michael L. Molinaro, *Single-Asset Real Estate Bankruptcies: Curbing an Abuse of the Bankruptcy Process*, 24 U.C.C. L.J. 161 (1991).

8. The bankruptcy trustee's strong arm powers are described in the United States Bankruptcy Code, 11 U.S.C. § 544(a) (1988). According to this provision:

> The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—
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> (1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;
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> (2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or
>
> (3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser

mortgagee has an absolute interest in rents—not just a security interest in them. Under the first extreme, the rents are not cash collateral because the *debtor* owns them free and clear. In the middle of the spectrum, rents are considered to be cash collateral or might become so if the secured party performs the postpetition perfecting ritual contemplated by § 546(b).[9] Finally, at the "absolute assignment" extreme, the rents are, once again, not cash collateral because the *secured party* owns them free and clear of the debtor.

The importance of cash flow control can be overestimated. For example, complete avoidance of the security interest on rent receivables does not imply that the mortgage lien on the real estate is invalid.[10] The secured party still is entitled to the value of the underlying real estate collateral. Thus, if a Chapter 11 plan is confirmed over the opposition of the secured party, such a creditor still is entitled to the present value of the real estate. Value is determined by computing the present value of future income, as measured

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exists.

9. Section 546(b) provides:

> The rights and powers of a trustee under section 544, 545, and 549 of this title are subject to any generally applicable law that permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of such perfection. If such law requires seizure of such property or commencement of an action to accomplish such perfection, and such property has not been seized or such action has not been commenced before the date of the filing of the petition, such interest in such property shall be perfected by notice within the time fixed by such law for such seizure or commencement.

11 U.S.C. § 546(b) (1988), *amended by* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, sec. 204, § 546(b), 108 Stat. 4106, 4122 (1994). The meaning of § 546(b) for security interests on rent receivables is of the utmost importance and is discussed *infra* in the text accompanying notes 252-60.

10. Avoidance, according to Craig Averch, "would permit a debtor to limit a creditor's secured claim under § 506(a) to the value of the land *less* the value of the income produced therefrom if the debtor files before the lien is 'created.'" Averch, *supra* note 6, at 518 n.5. This particular formulation denies the validity of the security interest on the reversion, because the security interest on the rent receivables is avoided in bankruptcy. Since sale of the reversion includes the sale of the existing receivables plus the sale of the potential to earn new rent receivables, the effect of lien avoidance is not as severe as Averch warns.

from the time the plan is confirmed.[11] The secured party, therefore, will have all income from the collateral following the plan's confirmation.

Meanwhile, if the security interest is valid and if all or most postpetition rents are considered cash collateral of the secured party, the possibility of reorganizing a single-asset real estate firm is by no means terminated. As a matter of state law and by virtue of Bankruptcy Code § 506(c), cash collateral must be used to maintain the property.[12] The validity of the security interest on rent receivables probably implies, however, that the bankrupt entity will have to find the means to pay the lawyers from new equity investments. All cash generated in a single-asset real estate case is likely to be cash collateral, and relatively few courts are willing to find that attorneys' fees in Chapter 11 cases are properly chargeable to secured parties under § 506(c).[13]

Equity owners are likely to pay for the chapter 11 proceeding because of the structure of the typical real estate deal. In such deals, the owner of the real property is a partnership and the mortgage is nonrecourse. This is so for

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11. Because secured parties are typically undersecured in single asset Chapter 11 cases, their prepetition claims are subdivided into secured and unsecured claims. If the holder of a bifurcated secured claim votes against the plan, she is entitled to the "cram down" protections of the Bankruptcy Code. According to § 1129(b)(2)(A)(i)(II), a debtor-in-possession may force a cram down on a secured party if the secured party retains the lien on the collateral and is given "deferred cash payments totaling at least the allowed amount of such claim, of a value, *as of the effective date of the plan*, of at least the value of such holder's interest in such estate's interest in such property." 11 U.S.C. § 1129(b)(2)(A)(i)(II) (1988) (emphasis added). Alternatively, the debtor may sell the collateral free and clear of the security interest and allow the security interest to attach to the cash proceeds. 11 U.S.C. § 1129(b)(2)(A)(ii) (1988). The debtor-in-possession also may give the secured party some "indubitable equivalent" of the above. 11 U.S.C. § 1129(b)(2)(A)(iii) (1988). All of these mechanisms guarantee the secured party the value of the collateral, which, in turn, guarantees the secured party income going forward from the effective date of the plan.

Thus, in BA Business Credit Corp. v. Di Toro (*In re* DiToro), 17 B.R. 836 (Bankr. E.D. Pa. 1982), *vacated*, 22 B.R. 392 (Bankr. E.D. Pa. 1982), the collateral was eventually abandoned before the mortgagee took any perfecting step with regard to the rents. At the later foreclosure sale, the mortgagee bid in its claim and was the buyer. Judge William King initially decided that the security interest in the rent receivables was void. But this lack of a security interest on rent receivables still allowed the mortgagee, as buyer, to collect all rents going forward. Only rents paid prior to the sale were disencumbered in favor of the bankruptcy trustee. *Id.* at 837-39. In a later decision, Judge Kinf reconsidered and decided that the trustee held the collected rents in constructive possession for the benefit of the mortgagee. *DiToro*, 22 B.R. at 394.

12. *See infra* text accompanying note 224. According to § 506(c), "the trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim." 11 U.S.C. § 506 (c)(1988).

13. A few precedents nevertheless exist. *See* Douglas L. Furth, et al., *Secured Creditors Playing to Win in a Single-Asset Real Estate Chapter 11 Case: Using 11 U.S.C. § 363, 506(c), and 1129 to Control a Case by Restricting Payment of the Debtor's Professional Fees From Collateral*, 4 J. Bankr. L. & Prac. 177 (1994); David Gray Carlson, *Secured Creditors and Expenses of Bankruptcy Administration*, 70 N.C. L. REV. 417, 484-90 (1992).

tax reasons.[14] Because the nonrecourse mortgage claim is by far the largest debt owed by the partnership, the individual partners are quite likely to be solvent even though their real estate partnership is under water. Accordingly, they can well afford to pay the attorneys' fees for the debtor partnership. Furthermore, should they lose control of the partnership to the lender, the lender will force a sale resulting in the realization of recapture income. Because partners are anxious to avoid a tax liability, they often are willing to pay lawyers, up to the amount of the tax liability, to prevent a foreclosure sale through a Chapter 11 proceeding.

At the extreme procreditor end of the spectrum, the rents are considered the sole property of the secured party and not property of the estate within the meaning of § 541(a). Such an interpretation poses a dire threat to the equity owners in a debtor partnership, but even here refinancing, however inconvenient, is possible. This result raises the cost of reorganization to the equity owners[15] because they must pay to maintain the property *and* pay the lawyers. Meanwhile, the secured party milks the property by taking away the rents.

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14. The structure of the typical real estate venture is key to the dialectic of the single-asset case in Chapter 11. *See generally* David Gray Carlson, *Artificial Impairment and the Single Asset Real Estate Bankruptcy*, 23 CAP. U. L. REV. 339, 347-45 (1995); Carlson, *supra* note 7, at 566-67. The real estate firm is almost certain to be a partnership, because of the flow-through nature of partnership taxation. Each partner reports her share of the partnership's income or, more typically because of the depreciation deduction that is allowed, loss on her own return. *See* 26 U.S.C. § 702 (1988). These losses shelter income presently and defer taxes until later.

The mortgage that finances the purchase of the real estate is likely to be a nonrecourse mortgage because of tax considerations. If a partnership has general and limited partners, a recourse mortgage imposes the risk of loss on the general partners for the full amount of the mortgage debt. *Cf.* REV. UNIF. PARTNERSHIP ACT § 306, 6 U.L.A. 247 (1993) (stating that partners are jointly and severally liable for the partnership's obligations unless agreed or provided otherwise). The limited partners have no liability for any deficit judgment. If a recourse mortgage goes into default, the partnership entity will be liable to the mortgagee, and depletion of the partnership estate means that the limited partners will lose the value they may have paid to obtain their limited partnership interests. Limited partners are not personally liable for partnership debts, however, in the same way as general partners. REV. UNIF. LTD. PARTNERSHIP ACT § 303, 6 U.L.A. 442 (1985). In such a case, the Internal Revenue Code limits the losses that the limited partners can deduct to their cash investments. *See* 26 U.S.C. §§ 704(d), 705 (1988). The effect is to deny the limited partners the benefit of the depreciation expense.

On the other hand, if the mortgage is nonrecourse, then the general partners are no more at risk than the limited partners. Thus, the Internal Revenue Code permits the depreciation deduction to be shared among all the partners—general and limited. Because there is no personal liability, limited and general partners are indistinguishable when the mortgage is nonrecourse.

15. Courts often assess that reorganization will be "impossible" if rents are not deemed cash collateral. *See, e.g.*, *In re* Growers Properties No. 56 Ltd., 117 B.R. 1015, 1015-16 n.1 (Bankr. M.D. Fla. 1990) (Baynes, J.). But such a description is too strong. Characterizing such reorganizations as very expensive would be a more accurate description.

When considering the validity of security interests on rent receivables, what is thus primarily at stake is who must pay the lawyers in Chapter 11. Naturally, equity owners would like the secured party to pay, and the secured party seeks to have the equity owners pay.

The Supreme Court has joined in high engendered battles over the temporary control of the cash flow. In *Butner v. United States*[16] the Supreme Court seemed to favor debtors by apparently ruling that bankruptcy courts may not intervene in the name of equity to help secured parties. Instead, the Court ordered bankruptcy judges to honor state law,[17] which often tends to be prodebtor.[18] Four years later, in *United States v. Whiting Pools, Inc.*,[19] the Supreme Court held that debtors-in-possession could recover collateral that secured parties repossessed before bankruptcy, even where the debtor possessed no equity in the collateral. This holding, involving a tax lien creditor, was soon applied to security interests on rent receivables and was very useful where the secured party had succeeded in dispossessing the debtor before the bankruptcy proceeding began.[20] Subsequently in 1988, the Supreme Court, in *United Savings Association v. Timbers of Inwood Forest Associates, Ltd.*,[21] ruled that undersecured creditors were not entitled to postpetition interest as part of their right to the adequate protection of their secured claims.[22] In essence, *Timbers* relieved debtors-in-possession of the obligation to pay debt service to undersecured creditors during the Chapter 11 proceeding. This proved to be an enormously valuable entitlement for debtors-in-possession, although its force in cases where the secured party claims a security interest on cash flow has been controversial.

By 1988, the Supreme Court had undersecured creditors on the run, but secured creditors claiming the cash flow still had a trump card. According to § 552(b) of the Bankruptcy Code, as it then existed:

> *Except as provided in* sections 363, 506(c), 522, *544*, 545, 547 and 548 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

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16. 440 U.S. 48 (1979).

17. *Id.* at 54-57.

18. This is the vulgar reading of *Butner*. Whether it is the correct reading is taken up later. *See infra* text accompanying notes 46-53.

19. 462 U.S. 198 (1983) (Blackmun, J.).

20. *See In re* Milford Common J.V. Trust, 117 B.R. 15, 16 (Bankr. D. Mass. 1990) (lavien, J.); *In re* Willowood East Apts., 114 B.R. 138, 144-45 (Bankr. S.D. Ohio 1990); Bryn Athyn Investors v. Hutton/Conam Realty Pension Investors (*In re* Bryn Athyn Investors), 69 B.R. 452, 457-58 (Bankr. E.D.N.C. 1987) (Small, J.).

21. 484 U.S. 365 (1988) (Scalia, J.).

22. *Id.* at 382.

> acquired before the commencement of the case and to . . . rents . . . of such property, then such security interest extends to such . . . rents . . . acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.[23]

This entitlement was, by its terms, made expressly subject to partial or total avoidance under a series of provisions—most of which are the very subject of this Article. But assuming the security interest in rent receivables survived avoidance by the trustee, § 552(b) seems to imply that all accruing rents belong to the secured party.

The right to accruing rents puts a secured party claiming real estate in a rather unique position. It means that, where the building is well maintained, the undersecured party is constantly improving her position over time. In other words, the secured claim of the undersecured party is constantly growing larger, and the unsecured claim of the same creditor is constantly growing smaller.[24] Such improvement in position is elsewhere generally thought to be contrary to bankruptcy policy.[25] Thus, Justice Scalia in *Timbers* complained that postpetition interest for undersecured parties would constitute an

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23. 11 U.S.C. § 552(b) (1988) (emphasis added), *amended by*, Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, sec. 214, § 552(b), 108 Stat. 4106, 4126 (1994). Section 552(b)(2) of the Bankruptcy Code has been amended in 1994 to include rent receivables. This new provision reads as follows:

> 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 . . . then such security interest extends to such rents . . . 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.

11 U.S.C.A. § 552(b)(2) (West Supp. 1995) (emphasis added).

Omitted from the above-quoted section are references to hotel receipts, which are now to be considered postpetition proceeds belonging to the secured party. *See id.* The emphasized language in the quote above is potentially significant for security interests in rent receivables and is discussed *infra* in the text accompanying notes 279-81.

24. This is the usual view that is taken of accruing rents. *See* Carlson, *supra* note 7.

25. For example, § 547(c)(5) of the Code takes careful pains to assure that secured parties claiming inventory or receivables do not improve their positions throughout the preference period. *See* David Gray Carlson, *Security Interests as Voidable Preferences under the Bankruptcy Code*, 1995 U. ILL. L. REV. 211 (1995). More precisely, sections 506(c) and 552(b) each take aim at improvement in position by undersecured creditors at the expense of the unsecured creditors.

improvement in position[26] —though, to be sure, he also noted that security interests in rents should permit such an improvement.[27]

As of 1992, the tools fully existed to deprive secured parties of the cash flow that § 552(b) seemed to endorse. Curiously, those tools had rarely been exploited. According to this theory, an undersecured creditor's prepetition claim had to be bifurcated into its perfectly secured and unsecured parts. The lien for the unsecured claim could then be avoided under § 506(d), which provided:

> To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such a lien is void, unless—
>
> (1) such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or
>
> (2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title.[28]

Before 1992, most people interpreted this section as avoiding the liens of undersecured creditors to the extent that the lien might benefit the postbifurcation unsecured claim. In essence, § 506(d) worked to guarantee for the debtor-in-possession a permanent bifurcation of the undersecured claim and, hence, any appreciation in value over time.[29]

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26. 484 U.S. 365, 372 (1988). Justice Scalia warned that if undersecured creditors could have postpetition interest, "the 'value of such creditor's interest' would increase, and the proportions of the claim that are secured and unsecured would alter, as the stay continues—since the value of the entitlement to use the collateral from the date of bankruptcy would rise with the passage of time. No one suggests this was intended." *Id.* On the nature and validity of this curious ratio of secured-to-unsecured debt, see David Gray Carlson, *Postpetition Interest Under the Bankruptcy Code*, 43 U. MIAMI L. REV. 577 (1989).

27. That some undersecured parties had a security interest on rents proved that secured parties without a security interest on rents had no right to postpetition interest:

> Section 552(b) . . . makes possession of a perfected security interest in postpetition rents or profits from collateral a condition of having them applied to satisfying the claim of the secured creditor ahead of the claims of unsecured creditors. Under petitioner's interpretation, however, the undersecured creditor who lacks such a perfected security interest in effect achieves the same result by demanding the "use value" of his collateral under § 362. It is true that § 506(b) gives the *over*secured creditor, despite lack of compliance with the conditions of § 552, a similar priority over unsecured creditors; but that does not compromise the principle of § 552, since the interest payments come only out of the "cushion" in which the oversecured creditor *does have* a perfected security interest.

28. 11 U.S.C. § 506(d) (1988).

29. *See* David Gray Carlson, *Undersecured Claims under Bankruptcy Code Sections 506(a) and 1111(b): Second Looks at Judicial Valuations of Collateral*, 6 BANKR. DEV. J. 253, 263-72 (1989).

There was no reason why § 506(d) could not be used to avoid a security interest on accruing rents.[30] Under a § 506(d) avoidance theory, the secured part of the undersecured claim would be capped forever at the value of the collateral, as measured at some specified time. Thereafter, any lien on rent receivables could not be used to secure the unsecured claim. At best, accruing rents could serve only as an equity cushion for the capped secured claim.[31] Occasionally, something like this did occur.[32] But before this theory could be developed,[33] the Supreme Court in *Dewsnup v. Timm*[34] eviscerated the theory, holding that § 506(d) served only to avoid liens where the entire claim was not allowable under § 502. Because of this holding, it is now well accepted that a secured party's position might improve over time.

There remain a few more possibilities for debtors to win control of cash flow. If the security interest in accruing rents could be shown to be partly or wholly invalid, the debtor-in-possession might again win at least temporary control of the cash flow, thereby shifting the cost of reorganization to the secured parties.

What makes the security interest in rent receivables vulnerable is that, under most state law, the debtor can disencumber rent receivables by collecting the rents. Often states insist that this power of collection continues until the secured party dispossesses the debtor from the real estate. Because the debtor has this power of collection, so do judicial lien creditors or bona fide purchasers from the debtor. The power to collect arises from the trustee's strong-arm powers,[35] as well as the definitions of perfection under the

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30. One might have pointed out that § 552(b) was expressly subject to § 506(c) or § 544, but not to avoidance under § 506(d). On the other hand, one could have argued that § 506(d) and § 552(b) are not even in conflict. Section 552(b) establishes the existence of a security interest on postpetition proceeds. It does not establish whether proceeds secure the undersecured deficit claim, or whether such proceeds constitute a new debtor equity to the bifurcated secured claim. Thus, § 552(b) preserves the security interest in proceeds, but § 506(a) and § 506(d) make it clear that such proceeds do not secure the unsecured deficit claim.

31. An equity cushion triggers a secured party's right to postpetition interest. *See* 11 U.S.C. § 506(b) (1988). But it is uncertain whether a bankruptcy trustee must keep the equity cushion in place while waiting for postpetition interest to accrue. *See* David Gray Carlson, *Oversecured Creditors Under Bankruptcy Code Section 506(b): The Limits of Postpetition Interest, Attorneys' Fees, and Collection Expenses*, 7 BANKR. DEV. J. 381, 390-94 (1990).

32. *See In re* Reddington/Sunarrow Ltd. Partnership, 119 B.R. 809 (Bankr. D. N.M. 1990) (McFeeley, J.); *see generally* Carlson, *supra* note 24.

33. The use of § 506(d) to disencumber rent receivables had been suggested in print a mere two weeks before *Dewsnup v. Timm*, 502 U.S. 410 (1992), was handed down, thereby giving this good idea short reign. *See* David Gray Carlson, *Time, Value, and the Property Rights of Secured Creditors in Bankruptcy, or Do Secured Creditors Have to Ask for Adequate Protection in Order to Get it?*, 1 J. BANKR. L. & PRAC. 113, 127-29 (1991).

34. 502 U.S. 410 (1992) (Blackmun, J.).

35. *See* 11 U.S.C. § 544(a) (1988).

trustee's power to set aside voidable preferences.[36] This derived power has given bankruptcy trustees hope that the security interest in rents might be avoided under the trustee's strong-arm power or under the bankruptcy trustee's power to recover voidable preferences.[37]

This hope may have been substantially increased by Congress's bizarre amendments to § 552 in 1994. Congress removed governance of rent receivables from a unified § 552(b) and placed them in a new § 552(b)(2), together with language that upholds security interests in hotel receivables. In the amendment, Congress indicated that the secured party could have postpetition rents "[e]xcept as provided in section[] . . . 544 *and notwithstanding section 546(b) of this title.*" As § 546(b) allows secured parties to beat the strong-arm power in § 544 by perfecting within a grace period under state law, the reference in new § 552(b)(2) to § 544 "notwithstanding" § 546(b) may be taken as intended to increase the ability of trustees to avoid security interests on rent receivables.

The legislative history, however, seems to indicate the opposite—that the author of the House bill intended to excuse mortgagees from avoidance, so long as the underlying mortgage was recorded. 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. This is accomplished by adding a new provision to section 552 of the Bankruptcy Code, applicable to lenders having a valid security interest which extends to the underlying property and the post petition rents.[38]

It is next to impossible to get this meaning from the statutory language itself,[39] and so, once again, the bankruptcy courts will have to choose

36. *See* 11 U.S.C. § 547(e)(1) (1988).

37. It may be noted that Congress recently has flirted with declaring all security interests on rent receivables immune from the strong arm power. *See* Forrester, *supra* note 5, at 394-96. Congress eventually elected not to help secured parties claiming rent receivables, leaving them to the vicissitudes of state law, as interpreted through the trustee's strong arm power. Congress amended § 552(b), however, to clarify that hotel receipts should be considered, like rents, to be proceeds of prepetition collateral, not postpetition accounts. *See* 11 U.S.C.A. § 552(b) (West Supp. 1995). Yet, the amendment does little to help secured parties establish the validity of their security interests in rent receivables.

38. 140 Cong Rec H. 10752, at H10768 (October 4, 1994) (statement of Congressman Brooks).

39. If "notwithstanding section 546(b)" modifies "except as provided in section [] . . . 544," then the amendment increases the power of bankruptcy trustees by depriving mortgagees of the ability to perfect within a state-law grace period. If "notwithstanding section 546" modifies the subsequent language guaranteeing a secured party the right to postpetition proceeds of prepetition collateral, then the amendment fails to overrule those holdings that allow the trustee to avoid

between following the plain meaning of the Bankruptcy Code or following some stray remark of a congressman on the floor of the house. As usual, the early returns favor the stray remark over the actual provisions of the Bankruptcy Code.[40]

Putting aside the 1994 amendments to § 552(b), the trend had been in favor of the secured lenders. Yet, the precise theory by which the secured party might prevail has never been entirely articulated, and many troublesome analytical problems have been papered over. As Judge Elizabeth Perris noted, "skipping the intermediate steps in the analysis may result in the confusion or blending together of different concepts with independent significance."[41] In the discussion to follow, no steps are skipped.

Before we visit the analytical difficulties, it is necessary to determine the extent to which state or federal law governs the validity of security interests in rent receivables. This is the province of the *Butner* opinion, which first commenced the Supreme Court's struggle with the difficult question of cash flow ownership.

Assuming that the security interest in rent receivables *is* valid in bankruptcy, we then consider whether, per *Whiting Pools*, the debtor-in-possession can recapture the right to collect rent from the secured party who, prior to bankruptcy, has already terminated the debtor's power to collect. The answer ought to be yes, although some cases assert that if the mortgage

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security interests on rent receivables, in whole or part, under § 544. Whatever "notwithstanding" modifies, it is impossible to read the amendment as actually cutting back on the trustee's avoidance powers.

40. *See In re* Newberry Square, Inc., 175 B.R. 910, 915 (Bankr. E.D. Mich. 1994) (Shapero, J.) ("The primary purpose of those amendments . . . was to provide lenders with valid security interests in post-petition rents notwithstanding their failure to have fully perfected those interests under state law"). According to Supreme Court jurisprudence, "a court may appropriately refer to a statute's legislative history to resolve statutory ambiguity . . ." Tobb v. Radloff, 501 U.S. 157, 162 (1991) (Blackmun, J.).

With regard to the legislative history of the 1994 amendments, Professor Janet Flaccus writes:

> The bill had an unusual history. It was passed by the Senate first, then the House waited until close to congressional recess to act on the bill. Since there was not enough time to pass a different bill and work out the differences with the Senate in conference, Senators and staffers interested in passage of the bill met with House members to work out differences before the bill passed the House. This was done. Thus, there is no conference report. This section-by-section review of the legislation was written after the compromise bill was agreed upon. I have found it to be quite accurate.

Janet A. Flaccus, *A Potpourri of Bankruptcy Changes: 1994 Bankruptcy Amendments*, 47 ARK. L. REV. 817, 821 n.30 (1994).

41. Scottsdale Medical Pavilion v. Mutual Benefit Life Ins. Co. (*In re* Scottsdale Medical Pavilion), 159 B.R. 295, 297 (Bankr. 9th Cir. 1993).

agreement labels the assignment of rents as "absolute," the rents are not cash collateral and no turnover is permitted. This result will be criticized for sanctioning a forfeiture in violation of Bankruptcy Code § 541(c)(1)(B) and, generally, for ignoring the nature of absolute assignments as mere security interests in rent receivables.

If the security interest in rent receivables is valid a bankruptcy trustee must provide "adequate protection" to the secured party in rent receivables. Otherwise, the secured party can insist that the automatic stay be lifted.[42] Yet, adequate protection is itself a controversial subject. Several different versions of adequate protection have been asserted by the bankruptcy courts. Accordingly, while continuing to stipulate the general validity of security interests in rent receivables, this Article next considers when the right to adequate protection arises. The longer this time is deferred, the better off debtors-in-possession will be.

After these preliminary matters are discussed, the avoidance powers will be analyzed. The avoidance powers consist of (1) the "equities" exception under § 552(b), which invites bankruptcy courts to terminate security interests in rents, (2) the trustee's strong-arm power, and (3) voidable preference law. The new amendment to § 552 greatly clouds the picture of the avoidance theory. The amendments could be interpreted to enable the trustee to use the strong-arm power to avoid the security interest on rent receivables entirely. Or, if we ignore the statutory language and follow the legislative history instead, the precise opposite conclusion will follow—no avoidance theory can adversely affect the secured party's right to cash collateral.

II. BUTNER V. UNITED STATES

The validity of the security interest on rent receivables is usually thought to depend upon local state law, as tested by the trustee's status as a hypothetical judicial lien creditor and bona fide purchaser of real property.[43] Prior to 1979, a minority of the circuits insisted that federal equity considerations should govern.[44] In 1979 the Supreme Court, in *Butner v. United States*,[45] ruled that state law governs the ownership of rents,[46] and, indeed, language

42. *See* 11 U.S.C. § 362(d)(1) (1988).

43. 11 U.S.C. § 544(a) (1988).

44. *See* Comment, *The Mortgagee's Right to Rents and Profits Following a Petition in Bankruptcy*, 60 IOWA L. REV. 1388 (1975).

45. 440 U.S. 48 (1979) (Stevens, J.).

46. *See id.* at 56-57. The federal government is now the largest secured creditor claiming security interests on rent receivables. The Supreme Court has ruled that federal law governs the attributes of these property interests, but as part of the federal common law, the federal government must adjust to the lien priorities of state. *See* United States v. Kimbell Foods, Inc., 440 U.S. 715 (1979) (Marshall, J.). Because the strong arm power is a matter of state lien

can be found in the opinion to that effect. Yet Justice John Paul Stevens affirmed a lower court opinion that deprived a secured party of its security interest in rents (duly perfected under state law) for failure to follow a *federal* rule of bankruptcy procedure. Thus, a descensus exists between what Justice Stevens said and what he did.[47] In addition, Stevens actually endorsed federal intervention to help out the secured party after all:

> [O]ur decision avoids the opposite inequity of depriving a mortgagee of his state-law security interest when bankruptcy intervenes. For while it is

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priorities, it must be assumed that the federal government obtains no special privileges in bankruptcy because it is the sovereign. *See generally* Frank S. Alexander, *Federal Intervention in Real Estate Finance: Preemption and Federal Common Law*, 71 N.C. L. REV. 293, 331-33 (1993).

Judge Donald Ross ruled to the contrary in United States v. Landmark Park & Assocs., 795 F.2d 683 (8th Cir. 1986), where a federal rule was invoked to overcome the effects of Mississippi law. Judge Ross noted that *Kimbell Foods* affirmed that federal law should apply to priorities of federal leaders and that *Butner* permitted deviation from state law when a federal interest was served. *Id.* at 684-85. Judge Ross found that protecting federal funds was a federal interest, *id.* at 686, even though Justice Thurgood Marshall rejected this very ground in Kimbell Foods; *see* 440 U.S. at 729 (stating, "We are unpersuaded that, in the circumstances presented here, nationwide standards favoring claims of the United States are necessary to ease program administration or to safeguard the Federal Treasury from defaulting debtors."). Furthermore, Judge Ross noted that deference to state law might be appropriate when state law is uniform, but not when state law is in disarray as it is with mortgages. 795 F.2d at 686.

For cases following the theory that the federal government is entitled to untrammeled victory in bankruptcy court, see Massachusetts Housing Fin. Agency v. Indian Motorcycle Assocs. III Ltd. Partnership (*In re* Indian Motorcycle Assocs. III Ltd. Partnership), 174 B.R. 351 (D. Mass. 1994) (Freedman, J.); United States v. Borden Fin. Corp., 164 B.R. 260 (Bankr. E.D. La. 1994) (McNamara, J.); Federal Home Loan Mortgage Corp. v. Nazar, 100 B.R. 555 (Bankr. D. Kan. 1989) (Crow, Jr.); *In re* Westwood Plaza Apartments, Ltd., 154 B.R. 916 (Bankr. E.D. Tex. 1993) (Abel, J.); *but see* United States, Farmers Home Admin. v. Buckley (*In re* Buckley), 73 B.R. 746, 748-49 (Bankr. D.S.D. 1987) (Jones, J.) (holding that because South Dakota law was standard, it should be incorporated into the federal law of mortgages).

47. In *Butner* the issue was whether accumulated rents from land belonged to the secured parties or the bankruptcy trustee. North Carolina law requires a mortgagee to dispossess the debtor of the property before the mortgagee is entitled to rent payments. Golden Enters. v. United States, 566 F.2d 1207, 1210 (4th Cir. 1977) (Winter, J.), *aff'd*, 440 U.S. 48 (1979). The mortgagees had obtained a receiver from the bankruptcy court and all sides agreed that this receiver was authorized to collect rents on behalf of the mortgagees. *See id.* (stating, "Of course, there had been a receiver until the adjudication in bankruptcy and he had applied the rents collected, *inter alia*, to the payment of interest and principal on the mortgages.").

When the debtor's proceeding was converted to a liquidation, the receiver was displaced by the bankruptcy trustee, who terminated Butner's right to the rents. Butner lost the rents because he made no separate request to the bankruptcy courts for the rents after his receiver was displaced. *See Butner*, 440 U.S. at 51; *Golden*, 566 F.2d at 1211 (Bryan, J., dissenting) (stating, "Despite the recital of other reasons, the majority decision actually turns on the single axis: that appellee, the second mortgagee, failed to renew '*during bankruptcy*' a request made during the arrangement phase for a sequestration of rents for his benefit.").

> argued that bankruptcy may impair or delay the mortgagee's exercise of his right to foreclosure, and thus his acquisition of a security interest in rents according to the law of many states, a bankruptcy judge familiar with local practice should be able to avoid this potential loss *by sequestering rents* or authorizing immediate state-law foreclosures.[48]

Therefore, even though *Butner* is supposed to stand for the supremacy of state law, its holding and even its dicta point in the opposite direction toward federal meddling with local regulation law.[49]

At best, *Butner* was a construction of the old Bankruptcy Act. As such, it was arguably overruled by § 552(b),[50] which guarantees to mortgagees the proceeds of and rent from their collateral, "except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise."[51] Although this clause strongly invites equitable intuition to displace state law, courts nevertheless have asserted the continuing vitality of *Butner* and its supposed insistence upon a state law rule.[52] Some courts,

48. 440 U.S. at 56-57 (emphasis added). For examples of bankruptcy courts sequestering rents on behalf of the mortgagee, even though the mortgagee made no move toward dispossessing the debtor or the trustee, see *In re* Mount Pleasant Ltd. Partnership, 144 B.R. 727, 736 (Bankr. W.D. Mich. 1992) (Stevenson, J.); BA Business Credit Corp. v. DiToro (*In re* DiToro), 22 B.R. 392 (Bankr. E.D. Pa. 1982) (King, J.).

49. *See* Sears Savs. Bank v. Tucson Indus. Partners (*In re* Tucson Indus. Partners), 129 B.R. 614, 623 (Bankr. 9th Cir. 1991) (Volinn, J.), *vacated as moot*, 990 F.2d 1099 (9th Cir. 1993); Patrick A. Randolph, Jr., *Recognizing Lenders' Rents Interests in Bankruptcy*, 27 REAL PROP. PROB. & TR. J. 281, 303-05 (1992). Some authorities accept that the *Butner* decision "has not proven to be especially helpful to the courts and the cases that have followed *Butner* have struggled in applying it's [sic] teachings." *In re* KNM Roswell Ltd. Partnership, 126 B.R. 548, 551 (Bankr. N.D. Ill. 1991) (Coar, J.).

50. *E.g.* Sandra Elzerman, Comment, *Interests in Collaterally Assigned Rents and Profits Under the Bankruptcy Code*, 22 HOUS. L. REV. 1251, 1258-59 (1985); Glenn R. Schmitt, *The Continuing Confusion Over Real Property Rents as Cash Collateral in Bankruptcy: The Need for a Consistent Interpretation*, 5 DEPAUL BUS. L.J. 1, 47-51 (1992); *see also* Butner, 440 U.S. at 54 (conceding that Congress can legislate a special rule for rents, if it wishes).

51. 11 U.S.C.A. § 552(b) (West Supp. 1995). *See* Wolters Village, Ltd. v. Village Properties, Ltd. (*In re* Village Properties, Ltd.), 723 F.2d 441, 444-46 (5th Cir. 1984) (Garza, J.) (hinting that the lower court might have applied the equities exception to vary state law, if such equities existed, but claiming that the *Butner* decision remains unscathed) *cert. denied*, 466 U.S. 974 (1984); *see also* Great-West Life & Annuity Assurance Co. v. Parke Imperial Canton, Ltd., 177 B.R. 843, 849 (N.D. Ohio 1994) (David, J.) (*Butner* overruled by Bankruptcy Code); *In re* TM Carlton House Partners, Ltd., 91 B.R. 349, 353 (Bankr. E.D. Pa. 1988) (Scholl, J.) (stating that § 552(b) "represents an attempt to soften slightly the strict adherence to state law directed by *Butner*").

52. *See* Nobleman v. American Sav. Bank, 113 S.Ct. 2106, 2110 (1993) (Thomas, J.); *In re*, Wheaton Oaks Office Partners Ltd. Partnership, 27 F.3d 1234, 1241 (7th Cir. 1994) (Manton, J.); Commerce Bank v. Mountain View Village, Inc., 5 F.3d 34, 37 (3d Cir. 1993) (Upiss, J.).

however, have suggested that *Butner* still requires a mortgagee to establish the lien through perfection under state law, but once established, the equities exception applies to whittle down the otherwise valid security interest.[53]

III. THE STATE LAW OF MORTGAGES

A. The U.C.C. Compared

To assess the validity of security interests on rent receivables, it becomes necessary to survey the state law of mortgages, most of which has been discovered, invented, or changed in recent bankruptcy litigation.[54] But first, to provide some comfort to bankruptcy lawyers who find the U.C.C. more familiar than nonuniform real estate law, it might be profitable to see how Article 9 governs the ownership of proceeds of accounts and general intangibles so that security interests on real estate receivables readily can be contrasted.

Under Article 9, a security interest in any piece of collateral is automatically a security interest in proceeds of the collateral as well.[55] If proceeds are cash collateral, the security interest in the cash continues to be perfected, so long as the original security interest in the collateral was perfected by filing.[56] Whether default has occurred, or whether the debtor is authorized

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53. *See In re* Rancourt, 123 B.R. 143, 145 n.1 (Bankr. D.N.H 1991) (Yacos, J.); Vienna Park Properties, Ltd. Partnership v. United Postal Savings Ass'n (*In re* Vienna Park Properties), 976 F.2d 106, 113 (2d Cir. 1992) (Meskill, J.) (inviting bankruptcy judges to reduce the security interest under the "equities" exception in § 552(b)); Randy Rogers, Note, *Assignment of Rents Clauses Under California Law and in Bankruptcy: Strategy for the Secured Creditor*, 31 HASTINGS L.J. 1433, 1441 (1980); *but see In re* Trans-Texas Petroleum Corp., 33 B.R. 67 (Bankr. N.D. Tex. 1983) (Flowers, J.) (using the "equitals exception" to *increase* the secured party's collateral over the amount state law supposedly would have provided). On the equities exception, see *infra* text accompanying notes 217-20.

54. Courts often discover that when a secured party and a debtor-in-possession duel over the right to post-petition rents, sparse local law almost never answers the question. *E.g.*, *In re* KNM Roswell Ltd. Partnership, 126 B.R. 548, 555 (Bankr. N.D. Ill. 1991) (complaining about the "paucity" of New Mexico law).

Meanwhile, in reaction to bankruptcy litigation, some state legislatures have enacted rules pertaining to the assignment of rents. *E.g.*, CAL. CIV. CODE § 2938 (West 1993); FLA. STAT. ANN. § 697.07 (West 1994); TENN. CODE ANN. § 66-26-116(a) (1993); WASH. REV. CODE ANN. § 7.28.230(3) (West 1992). For a discussion of such legislation, see Bonnie K. Donahue & W. David Edwards, *The Treatment of Assignments of Rents in Bankruptcy: Emerging Issues Relating to Perfection, Cash Collateral, and Plan Confirmation*, 48 BUS. LAW. 633, 654-68 (1993).

55. U.C.C. § 9-306(2), 3A U.L.A. 162 (1990) (stating that "except where this Article otherwise provides, a security interest continues in collateral notwithstanding sale . . . and also continues in any identifiable proceeds including collections received by the debtor").

56. U.C.C. § 9-306(3)(b), 3A U.L.A. 162 (1990).

to collect and spend the cash, the security interest continues in the proceeds so long as they are identifiable.[57] For example, imagine these three different collections: (1) A debtor, prior to default, collects an account encumbered by a security interest. (2) The debtor is in default, but nevertheless collects a second account. (3) The secured party intercedes and notifies a third account debtor to pay the secured party directly,[58] and the account debtor does so.

Under Article 9, the secured party has a security interest in all of these proceeds.[59] As we shall discover, nonuniform real estate law infrequently recognizes a security interest on the first or second types of collection. Only the third type of collection is universally conceded to preserve the secured party's rights to the proceeds of rent receivables. Most typically, if the debtor collects, the security interest is effectively disencumbered.

B. Mortgage Liens Only

As a preliminary matter, it is important to understand who owns the rents if a mortgage agreement contains no express assignment of rent receivables. We may start with the premise that rent arises from a leasehold estate in land. Leaseholds imply the obligation of the lessee to pay rent to the owner of the reversionary interest.[60] Therefore, it is a principle of real estate law that dominion over the reversion, a nonpossessory future interest in real estate, implies a right to receive rent from all tenants.[61]. For example, a sale of the

57. U.C.C. § 9-205, 3 U.L.A. 486 (1990) (stating that "a security interest is not invalid or fraudulent against creditors by reason of liberty in the debtor to use . . . collateral (including returned or repossessed goods) or to collect . . . accounts or . . . dispose of proceeds, or by reason of the failure of the secured party to require the debtor to account for proceeds or replace collateral.").

58. U.C.C. § 9-502(1), 3B U.L.A. 43 (1990) (stating "when so agreed and in any event on default the secured party is entitled to notify an account debtor or the obligor on an instrument to make payment to him whether or not the assignor was theretofore making collections on the collateral, and also to take control of any proceeds to which he is entitled under Section 9-306.").

59. This represents a reversal of Benedict v. Ratner, 268 U.S. 353 (1925) (Brandeis, J.). In *Benedict*, Justice Louis Brandeis ruled that under New York law any security interest in accounts that allowed the debtor to control the proceeds was invalid in bankruptcy. Id. at 360 ("Under the law of New York a transfer of property as security which reserves to the transferor the right to dispose of the same, or to apply the proceeds thereof, for his own uses is, as to creditors, fraudulent in law and void.") (footnote omitted). Hence, the security interest in the first two accounts were void, and the third was valid, although perhaps a voidable preference under federal law. *See id.* at 364-65. Thus, the only way a secured party could finance accounts was by controlling the collections from the beginning.

For praise of *Benedict*, see 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 8.3 (1965).

60. *In re* Wheaton Oaks Office Partners Ltd. Partnership, 27 F.3d 1234, 1241 (7th Cir. 1994); 1 AMERICAN LAW OF PROPERTY § 3.64 (A. James Casner ed. 1952 & Supp. 1977).

61. For this reason, Judge Shiff ruled that a real estate mortgagee claiming residential real

reversionary interest is automatically the sale of the existing real estate receivables connected with the reversion.

A security interest on the reversion in turn implies that, prior to default, the debtor continues in dominion and, therefore, continues to have the right to collect rent. So far, real estate law follows the U.C.C. pattern, but we must acknowledge an important difference. Whereas under the U.C.C. the secured party continues to own the dollars a debtor collects from accounts receivable, the secured party typically does not own collected dollars under real estate law. Rather, the debtor disencumbers any rents the debtor actually collects. Such dollars are owned free and clear of the security interest.

This key distinction may no longer be valid in some states because of recent statutory reform. In 1989, the state of Washington enacted the following provision:

> The recording of an assignment, mortgage, or pledge of unpaid rents and profits of real property, intended as security . . . shall immediately perfect the security interest . . . and shall not require any further action by the holder of the security interest to be perfected as to any subsequent purchaser, mortgagee, or assignee. Any lien created by such an assignment, mortgage, or pledge shall, when recorded, be deemed specific, perfected, and choate.[62]

In divining the nature of this enactment, Judge Sydney Volinn, in *In re Park at Dash Point, Ltd. Partnership*,[63] analogized the debtor's power to disencumber rents to a judicial lien creditor's rights to collect an account encumbered by a perfected Article 9 security interest.[64] If the meaning of the new Washington statute is to make the mortgagee the owner of proceeds of rent receivables, even after the debtor or, derivatively, a judicial lien creditor or purchaser collects them, then Judge Volinn's analogy is correct. A judicial lien creditor has a derivative power to collect under U.C.C. section 9-318(3) in the sense that the account debtor satisfies her debt obligation if she pays the lien creditor. Yet, these cash proceeds collected by the lien creditor would still belong to the senior secured party. If the judicial lien creditor were to

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estate is still protected under § 1322(b)(2)—claims "secured only by . . . 'the debtor's principal residence'"—if the mortgage encumbers rents. *In re* Spano, 161 B.R. 880, 884-87 (Bankr. D. Conn. 1993). Mortgages encumber rents by their very nature. *Cf.* Hammond v. Commonwealth Mortgage Corp. of America (*In re* Hammond), 27 F.3d 52, 56-57 (3d Cir. 1994) (recognizing that claim to rents meant forfeiture of immunity to impairment).

62. WASH. REV. CODE ANN. § 7.28.230(3) (West 1992).

63. 121 B.R. 850 (Bankr. W.D. Wash. 1990), *aff'd*, 152 B.R. 300 (D. Wash. 1991), *and aff'd*, 985 F.2d 1008 (9th Cir. 1993).

64. *See Dash Point*, 121 B.R. at 855-56.

expropriate these funds to her own use, she has committed the tort of conversion and is liable to the secured party.[65]

This summary of Washington law is somewhat speculative, as there are some ambiguities in the Washington statute. First, the statute indicates that the mortgagee is to be "superior" to purchasers. It does not quite say that the debtor has lost the power to disencumber rents by collecting them. Yet, superiority over purchasers might suggest that the dollars collected still belong to the secured party. This will have to await a test case. For example, if the debtor sells the equity in real estate to a purchaser who then collects rent, a court must be willing to hold that purchaser guilty of the tort of conversion with regard to any rents collected.[66] This is the radical result of adopting the U.C.C.-style rule for proceeds in real estate cases.

Second, the new Washington statute subordinates only voluntary purchasers. Nonpurchasers, such as judicial lien creditors, are not mentioned. Still, judicial lien creditors usually obtain less, not more, protection, from prior real estate encumbrances. It is unlikely that the Washington Legislature consciously intended that the mortgagee should be superior to subsequent purchasers, but inferior to subsequent judicial lien creditors. This last point has important bankruptcy consequences because the bankruptcy trustee is both a judicial lien creditor and a bona fide purchaser of real estate as of the time of the bankruptcy petition.[67]

Similar to Washington, Tennessee recently declared security interests on rent receivables to be "perfected as to . . . all third parties" when the mortgage is recorded.[68] In *Creekstone Apartments Associates v. Resolution*

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65. In *In re* Stone Ridge Assocs., 142 B.R. 967 (Bankr. D. Kan. 1992), Judge John Flannagan, in dictum, read KAN. STAT. ANN. § 58-2343 as adopting the U.C.C. model of proceeds law:

> While this statute is not applicable to the present controversy, it aims to change the present case law holding that the mortgagee must obtain actual possession of the rents before its lien can prevail over a judicial lien creditor or transferee of the mortgagor. Read literally, the statute means that the mortgagee has a lien from the date of recording . . . enforceable against rents traceable to any party dealing with the mortgagor before or after default. The implications for third parties are frightening. In their zeal to effectuate the relation-back mechanism of Bankruptcy Code § 546(b), sponsors of this measure may have created a monster.

142 B.R. at 971 n.9.

66. When faced with this test, the Supreme Court of Texas blanched and acquitted the mortgagee of tort liability for expropriating rents. *See* Taylor v. Brennan, 621 S.W.2d 592, 595 (Tex. 1981) (McGee, J.); *see also* Miners Sav. Bank v. Thomas, 140 Pa. Super. 5,8, 12 A.2d 810, 812 (1940) (Keller, J.) (judicial lien creditor could keep all rents actually collected, but could also be ousted by senior mortgage).

67. *See* 11 U.S.C. § 544(a) (1988).

68. TENN. CODE ANN. § 66-26-116(a) (1993) provides:

> Upon registration . . . the interest of the grantee . . . shall be fully perfected as to the grantor, transferor, pledgor or assignor and all third parties without the

Trust Corp. (In re Creekstone Apartments Associates),[69] Judge George Paine interpreted this provision to mean that a U.C.C.-type rule concerning rent receivables had been instituted wherein the secured party had priority over any given purchaser or lien creditor as to any rent dollar collected.[70] But, when put to the test—whether recipients of encumbered dollars should be held guilty of the tort of conversion—he lost his nerve. Inconsistently, he ruled that because the secured party had not yet taken the necessary "enforcement steps" for its security interest,[71] the debtor could use rents actually collected to pay, for example, the debtor's attorneys. In short, Paine treated the rent receivables as disencumbered when collected. Therefore, it appears that the rent receivables were unperfected after all. If Tennessee really intended to institute the U.C.C. model for real estate proceeds, then the amounts paid from such proceeds should have been deemed wrongfully converted by anyone who interferes with or accepts such funds.[72] One suspects that Tennessee law, as interpreted by Judge Paine, perhaps wants it both ways. On the one hand, the statute establishes the security interest on rent receivables as valid in bankruptcy. On the other hand, it allows the debtor to disencumber the rents. These are inconsistent propositions. If the latter is true, then bankruptcy courts, applying the hypothetical bona fide purchaser test of § 544(a)(3), should view Tennessee security interests on rent receivables as unperfected.

Other examples of recent legislation are even less clear in their effect on rent receivables. Thus, whereas Washington's statute proclaims that the secured party's security interest is perfected "as to any subsequent purchaser, mortgagee, or assignee,"[73] other legislation simply proclaims the security interest "perfected," as if the meaning of that word were self-evident.[74]

> necessity of furnishing notice to the assignor or lessee, obtaining possession of the real property, impounding the rents, securing the appointment of a receiver, or taking any other affirmative action, and shall have the priority provided for in this chapter.

69. 165 B.R. 845 (Bankr. M.D. Tenn. 1993).

70. *See id.* at 849; *see also* Wilhite Pure Oil Truck Stop, Inc. v. McCutchen (*In re* McCutchen), 115 B.R. 126 (Bankr. W.D. Tenn. 1990) (Brown, J.). Some states allow invocation of the U.C.C. rule by contract. *See, e.g.*, ARIZ. REV. STAT. ANN. § 33-702(B) (1990); Provident Mut. Life Ins. Co. v. Winslow Ctr. Assocs. (*In re* Winslow Ctr. Assocs.), 50 B.R. 679, 681 (Bankr. E.D. Pa. 1985) (applying New Jersey law).

71. 165 B.R. at 851.

72. The theories under which the attorneys or the bank would be liable to the secured party for the conversion of cash proceeds of rent receivables are exceedingly complex and brilliantly analyzed in Robert H. Skilton, *The Secured Party's Rights in a Debtor's Bank Account Under Section 9-306(4) of the Uniform Commercial Code*, S. ILL. U.L.J. 120, 144-86 (1977); *see also In re* EES Lambert Assocs., 43 B.R. 689, 692 (Bankr. N.D. Ill. 1984) (Martin, J.), *aff'd*, 63 B.R. 174 (N.D. Ill. 1986) (finding that lawyers must return retainer paid out of rent proceeds).

73. WASH. REV. CODE ANN. § 7.28.230(3) (West 1992).

74. *See, e.g.*, CAL. CIV. CODE §§ 2938, § 2938.1 (West 1993); MD. CODE ANN. REAL PROP. § 3-204 (Supp. 1994).

For our purposes, the key issue must always be, who owns an identifiable rent dollar after the debtor collects it? If the answer is that the secured party has a security interest on such a dollar, then local real estate law conforms to the U.C.C. Such a security interest means that the cash flow is always cash collateral in bankruptcy. In contrast, if the debtor owns the rent dollars free and clear, then the security interest may not work to establish a perfectly valid security interest in bankruptcy.

Putting aside these attempts at legislative reform, in most states, the rents, once collected by the debtor, are "severed" from the real estate, and the dollars actually collected belong to the debtor free and clear of the security interest on the rent receivables.[75] Thereafter, any postseverance contractual arrangement that forces the debtor to segregate collected dollars for the benefit of the secured party is likely to be viewed as an attempt to create an Article 9 security interest, which would then have to be perfected according to the rules found therein.[76]

75. There is controversy on precisely when the debtor disencumbers the security interest on the rent receivables. Some authorities assume that as soon as the tenant's obligation to pay the debtor becomes unconditional, the secured party's security interest on the receivable is divested, even before the debtor collects. Under this view, if a secured party notifies a tenant on October 2 to pay the secured party and if the tenant has not yet paid the September rent, the tenant owes the September rent to the debtor free and clear of the mortgage lien and owes the October rent to the secured party. *See, e.g.*, Casbeer v. State Fed. Sav. & Loan Ass'n (*In re* Casbeer), 793 F.2d 1436, 1443-44 (5th Cir. 1986) (Gee, J.) ("[t]he district court erred to the extent that it concluded that post-petition rentals from a given property that accrued before perfection represented cash collateral under § 363(a)."); Balcor Pension Investors V v. Wiston XXIV Ltd. Partnership (*In re* Wiston XXIV Ltd. Partnership), 147 B.R. 575, 582 n.10 (D. Kan. 1992) (Saffels, J.), *appeal dismissed*, 988 F.2d 1012 (105h Cir. 1993); *In re* Rancourt, 123 B.R. 143, 149 (Bankr. D.N.H. 1991) (Yacos, J.); *In re* Wynnewood House Assocs., 121 B.R. 716, 723 (Bankr. E.D. Pa. 1990) (Fox, J.) (applying Pennsylvania law) (following this rule when an intervening lien creditor appears, but not when the mortgagee directly instructs tenants to pay all rents to mortgagee); *In re* KNM Roswell Ltd. Partnership, 126 B.R. 548, 554 (Bankr. N.D. Ill. 1991) (Coar, J.) (applying New Mexico law); United States v. Farrell (*In re* Fluge), 57 B.R. 451, 456-57 (Bankr. D.N.D. 1985) (Hill, J.); Exchange Nat'l Bank v. Gotta (*In re* Gotta), 47 B.R. 198, 202 (Bankr. W.D. Wis. 1985) (Martin, J.).

It is not so much accrual before perfection as it is whether the tenant has actually paid. The tenant is privileged to pay the debtor until notified otherwise by the secured party. *Cf.* U.C.C. § 9-318(3), 3A U.L.A. 461 (1972). Even if rent is overdue, the secured party should be able to obtain a senior right to be paid from the tenant, even after a judicial lien creditor or purchaser also has notified the tenant that she expects to be paid. *See, e.g., In re* Polo Club Apartments Assocs. Ltd. Partnership, 150 B.R. 840, 854 (Bankr. N.D. Ga. 1993) (Cotton, J.). The notion that accrued rents belong to the debtor or to a judicial lien creditor is probably connected with the mistaken notion that the tenant's obligation to pay rent in the future is not an obligation that exists today. But if this is correct, then the security interest on the rent receivables is essentially a security interest on after-acquired property and, hence, vulnerable to a voidable preference theory. Later, a contrary theory, that the security interest is not a voidable preference, will be offered. *See infra* text accompanying notes 318-19.

76. First Nat'l Bank v. United States (*In re* Dorsey), 155 B.R. 263, 269 (Bankr. D. Me.

It is sometimes alleged that the debtor's power to collect free and clear of the security interest on rent receivables proves that the security interest is unvested,[77] "inchoate,"[78] or even nonexistent.[79] These terms are misleading.[80] Rather, any mortgage lien constitutes a valid security interest on rent receivables. The debtor, however, has the power to disencumber the rent receivables by collecting them.[81] This power to disencumber may be compared to the debtor's power to disencumber security interests on inventory by selling them in the ordinary course of business.[82] No one would say that security interests in inventory do not exist because the debtor has the power to disencumber the security interests by selling the inventory in the ordinary course of business. Accordingly, it is best to say that the mortgagee has a presently existing lien on the rent receivables, but this lien is subject to a condition subsequent. The condition subsequent is the debtor's power to collect the rents free and clear of the mortgage lien. The termination of this

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1993) (Haines, J.). To the extent the money is in a deposit account, Article 9 does not apply, although any lien on such account would still be in the province of personal property law. U.C.C. § 9-104(*l*), 3 U.L.A. 180 (1990). If post-severance money is put into some sort of escrow arrangement that is not a deposit account, Article 9 is fully applicable. Vienna Park Properties v. United Postal Savings Ass'n (*In re* Vienna Park Properties), 976 F.2d 106, 114 (2d Cir. 1992) (finding Article 9 applicable to an escrow account); Lowe v. Sheinfeld, Maley & Kay (*In re* Saunders), 155 B.R. 405 (Bankr. W.D. Tex. 1993) (Clark, J.) (finding Article 9 applicable to real estate owned by partnership where partner pledged his share of rents after collection).

77. *See* Provident Mut. Life Ins. Co. v. Winslow Ctr. Assocs. (*In re* Winslow Ctr. Assocs.), 50 B.R. 679, 681 (Bankr. E.D. Pa. 1985) (Goldhaber, C.J.) (applying New Jersey law).

78. Vienna Park Properties, 976 F.2d at 112-13 (applying Virginia law).

79. Some courts think that the secured party has "no right" to rent receivables until the debtor is dispossessed. Commerce Bank v. Mountain View Village, Inc., 5 F.3d 34, 39 (3d Cir. 1993) (Weis, J.) (stating, "We recognize that mortgagees have *no right* to the rents until a default has occurred and, before they give notice, a junior lienor can attach rents that otherwise would come into the possession of the mortgagor." (emphasis added)); *In re* Harvey Road Assocs., 140 B.R. 302, 305 (Bankr. D. Mass. 1992) (Hillman, J.) (applying New Hampshire law); *In re* KNM Roswell Ltd. Partnership, 126 B.R. 548, 553 (Bankr. N.D. Ill. 1991) (Coar, J.) ("Until the borrower defaults the assignee has no rights to the rents."). This demonstrates the standard confusion between contingent property rights and no property rights. If correct, then the security interest has not attached to the receivable at all. The security interest becomes a springing lien that is invalid if it springs after the start of the preference period.

In fact, Judge David Coar, in *KNM Roswell*, goes on to describe an existing security interest in rents that can be asserted against a lien creditor or purchaser who takes over the debtor's right to collect. *See id.* at 553. This description contradicts the notion that the secured party had no rights in rent receivables prior to enforcement. Rather, the contingent right existed all along.

80. *In re* Rancourt, 123 B.R. 143, 148 (Bankr. D.N.H. 1991) (Yacos, J.) (denouncing such terminology).

81. *See* Averch, *supra* note 6, at 526.

82. U.C.C. § 9-307(1), 3A U.L.A., 256 (1993) (stating that "a buyer in ordinary course of business . . . takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence").

debtor power will be analyzed as the lapse of a condition, not a transfer of debtor property.[83]

C. Supplemental Assignments of Rent

So far we have been pondering the effect of a mortgage lien on rent receivables. In addition to the bare mortgage lien on the reversion, a security agreement may expressly set forth an additional assignment of the rents.[84] Often the assignment reserves to the debtor the right, prior to default, to collect rent free and clear of the security interest. It may be thought that such an assignment, therefore, adds nothing to the basic mortgage on the reversionary interest itself, but this is not necessarily so. First, state law usually puts a gloss on what is meant when a mortgagee takes possession of the reversionary interest. The assignment of rents often purports to change that gloss. Thus, if dispossession of the debtor ordinarily requires the appointment of a receiver or other incident of judicial seizure of the property itself, the parties, by means of an assignment of rents, may agree to terminate the debtor's control of the rents at some other time.[85]

Thus, in Illinois, the debtor is entitled to retain possession, and the power to collect rents, until after the foreclosure sale and postsale redemption period. But, per an assignment of rents, the agreement may provide for an earlier

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83. To those who equate "possession" with the sensuous grasping of property with one's hands, possession of a future interest in real estate may seem problematic terminology. How could a debtor owning a future interest be dispossessed when the future interest itself is a nonpossessory interest in real estate? Yet, the term "possession" should not be so limited. Indeed, feminist scholars assure us that any such conception is evidence of infantile phallic metaphoric error. *See* Jeanne L. Schroeder, *Chix Nix Bundle-O-Stix: A Feminist Critique of the Disaggregation of Property*, 93 MICH. L. REV. 239 (1994). Instead, possession actually means dominion or control or what real estate lawyers call "privity of estate."

84. A mortgage agreement is usually required to contain an express assignment of rents; if no such assignment exists, then the mortgagee has no interest in rents until the mortgagee retakes possession of the collateral. *In re* Prichard Plaza Assocs., 84 B.R. 289, 294 (Bankr. D. Mass. 1988) (Queenan, J.) (applying Massachusetts law).

85. *See, e.g.*, Fidelity Bankers Life Ins. Co. v. Williams (*In re* O'Neill Enters.), 506 F.2d 1242 (4th Cir. 1974) (Haynesworth, J.) (applying Virginia law); *In re* May, 169 B.R. 462, 466-67 (Bankr. S.D. Ga. 1994) (Davis, J.); *In re* Tripplet, 84 B.R. 84, 88 (Bankr. W.D. Tex. 1988) (Avyers, C.J.); *Cf.* Freedman's Saving & Trust Co. v. Shepherd, 127 U.S. 494, 502 (1888) ("It is, of course, competent for the parties to provide, in the mortgage, for the payment of rents and profits to the mortgagee, while the mortgagor remains in possession"); *In re* Centre of Mo. Ltd., 116 B.R. 138, 141 (Bankr. E.D. Mo. 1990) (Barta, J.) (recognizing that parties may agree to change the point at which the debtor's right to collect rents ends); Otis Elevator Co. v. Mid-American Realty Investors, 206 Mich. App. 710, 522 N.W.2d 732 (1994) (Shepherd, J.) (judgment creditor could not garnish tenants after mortgage default occurred). *But cf.* South Plaza Ventures, 167 B.R. 535, 539 (Bankr. E.D. Mo. 1994) (Barta, J.) (explaining that Missouri law does not honor such contracts).

termination of the debtor's right to collect rents.[86] In Wisconsin, the parties may agree that a default automatically terminates the debtor's power to collect rents, but courts also require some "affirmative action" by the secured party to terminate this power.[87] In Georgia, an act of taking "control" of the rents might be construed to terminate the debtor's right to collect, for example, sending a letter to the managing agent announcing that the agent must stop giving rents to the debtor.[88] Additionally, in Arizona, Maine, and Virginia, the parties may agree that pure default terminates the debtor's right to collect rent regardless of whether the secured party takes any affirmative action.[89]

Often state law does not honor the assignment of rents at all. Many states require the mortgagee to take possession of the reversion through the appointment of a receiver before she may collect rents regardless of contrary language in the mortgage.[90] Because possession of the reversion implies the right to rent, how does the assignment add anything that was not already inherent in the concept of the mortgage on the reversion? In short, when courts insist that the secured party must always obtain a receiver to collect rents, state law effectively prohibits any assignment of rents separate and apart from the mortgage.[91]

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86. *In re* Wheaton Oaks Office Partners, 27 F.3d 1234, 1241-42 (7th Cir. 1994) (Manion, J.).

87. *In re* Century Investment Fund VIII Ltd. Partnership, 937 F.2d 371, 377 (7th Cir. 1991) (Jones, J.) (footnote omitted) (citing Lincoln Crest Realty v. Standard Apartment Dev., 211 N.W.2d 501 (1973); First Wis. Trust Co. v. Adams, 261 N.W. 16 (1935)).

88. Empire Fin. Servs., Inc. v. Gingold (*In re* Real Estate West Ventures), 170 B.R. 736, 741 (Bankr. N.D. Ga. 1993) (Dighe, J.); *contra*, Jones v. United States (*In re* Jones), 77 B.R. 981 (Bankr. M.D. Ga. 1987) (Lancy, J.) (explaining that parties can agree that the secured party owns rents immediately upon default).

89. *See* Scottsdale Medical Pavilion v. Mutual Benefit Life Ins. Co. in Rehabilitation (*In re* Scottsdale Medical Pavilion), 159 B.R. 295, 299-300 (Bankr. 9th Cir. 1993) (applying Arizona law); *In re* Somero, 122 B.R. 634, 638 (Bankr. D. Me. 1991) (Goodman, J.); Eastern Savs. Bank v. Epco Newport News Assocs. (*In re* EPCO Newport News Assocs.), 14 B.R. 990, 996 (Bankr. S.D.N.Y. 1981) (Ryan, J.) (applying Virginia law). For an argument that default as a condition is too confusing in light of cure, see Randolph, *supra* note 49, at 300-03 (1992).

90. *See, e.g.*, *In re* Anderson, 50 B.R. 728, 732 (D. Neb. 1985) (Beam, J.) (claiming that the assignment was enforceable, but still requiring a receiver to dispossess the debtor); *In re* South Plaza Ventures, 167 B.R. 535, 539 (Bankr. E.D. Mo. 1994) (Barta, J.) (applying Missouri law); Empire Fin. Servs., Inc., 170 B.R. at 741 (Bankr. N.D. Ga. 1993) (Drake, J.); *In re* Polo Club Apartments Assoc., 150 B.R. 840, 851 (Bankr. N.D. Ga. 1993) (Cotton, J.) (applying Georgia law) (noting also the conditional nature of the assignment clause); *In re* Mews Assocs., 144 B.R. 867, 868-69 (Bankr. W.D. Mo. 1992) (Federman, J.); *In re* Stanley Station Assocs., 139 B.R. 990, 1009 (Bankr. D. Kan. 1992) (Flannagann, J.) (applying Kansas law); *In re* Park at Dash Point, Ltd. Partnership, 121 B.R. 850, 855-56 (Bankr. W.D. Wash. 1990) (Volinn, J.) (applying Washington law), *aff'd sub nom.* Steinberg v. Crossland Mortgage Corp. (*In re* Park at Dash Point, Ltd. Partnership), 152 B.R. 300 (D. Wash. 1991), and *aff'd sub nom.* Steinberg v. Crossland Mortgage Corp. (*In re* Park at Dash Point, Ltd. Partnership) 985 F.2d 1008 (9th Cir. 1993); Drummond V. Farm Credit Bank (*In re* Kurth Ranch), 110 B.R. 501, 506 (Bankr. D. Mont. 1990) (Peterson, J.).

91. The reasons for this hostility to freedom of contract seem vaguely connected with the

Although courts often worry about whether relevant case law follows the lien theory or the title theory of mortgages,[92] they need not bother. The metaphysical inquiry that locates title or privity of estate has no relevance to the meaning of the assignment of rents.[93] The real issue is the extent to which state law permits freedom of contract in defining the terms of default. The answer to this question cannot be improved by the useless drudgery of locating where feckless title resides.[94]

IV. TURNOVER

When the secured party has taken over collection of the rents by the time of the bankruptcy petition—whether by obtaining a receiver, notifying the tenants, or otherwise—the amounts collected prepetition (or at least before the voidable preference period of ninety days),[95] are beyond the reach of the bankruptcy trustee.[96] Such rents, if they have already been collected, will have been applied to the mortgage debt, and the debtor's property right to these dollars will have ended.

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sanctity and logic of the debtor's possession of the reversionary interest in real estate. *See* Note, *The Mortgagee's Right to Rents After Default*, 50 YALE L.J. 1424, 1426-27 (1941). The instinct expressed in this note seems to be similar to the logic of Benedict v. Ratner, 268 U.S. 353 (1925), discussed *supra*, note 59.

92. *See, e.g.*, Butner v. United States, 440 U.S. 48, 51 (1979) (Stevens, J.) (applying North Carolina law); Commerce Bank v. Mountain View Village, Inc., 5 F.3d 34, 37-38 (3d Cir. 1993) (Weis, J.) (applying Pennsylvania law and the title theory); Wolters Village, Ltd. v. Village Properties, Ltd. (*In re* Village Properties, Ltd.), 723 F.2d 441, 443 (5th Cir. 1984) (Garza, J.), *cert. denied*, 466 U.S. 974 (1984) (applying Texas law).

93. Some authorities recognize this. *See, e.g., In re* Rancourt, 123 B.R. 143, 147 & n.2 (Bankr. D.N.H. 1991) (Yacos, J.); Note, *supra* note 91, at 1425.

94. According to Professor Frank Alexander:

> The most significant issue dividing title and lien theory states was the creditor's right to possession of the land before foreclosure. . . .
>
> Historically, the title theory, with its premise of a transfer of title to the mortgagee, affirmed the rights of the mortgagee to possession, as well as to rents and profits, immediately upon default. In contrast, lien theory jurisdictions denied a mortgagee an action in ejectment against the mortgagor; the mortgagee could obtain protection of the rents and profits only through foreclosure or the appointment of a receiver.

Alexander, *supra* note 46, at 303 (footnotes omitted). For a lucid history of the title-lien distinction, see August v. Michigan Ave. Nat'l Bank (*In re* Michigan Ave. Nat'l Bank), 2 B.R. 171, 179-82 (Bankr. N.D. Ill. 1980) (Merrick, J.); Robert Kratovil, *Mortgages—Problems in Possession, Rents, and Mortgagee Liability*, 11 DEPAUL L. REV. 1, 4-6 (1961).

95. The effect of voidable preference law on prepetition collections of rent by an undersecured creditor is discussed *infra* in the text accompanying notes 315-19.

96. *E.g., In re* 5028 Wisconsin Ave. Assocs., 167 B.R. 699, 704 (Bankr. D.D.C. 1994) (Teel, J.); *In re* Bethesda Air Rights, Ltd. Partnership, 117 B.R. 202, 209 (Bankr. D. Md. 1990) (Derby, J.).

Nevertheless, the real estate receivables themselves, to the extent that they have not been collected, are subject to turnover to the trustee.[97] If the secured party has not obtained a "custodian,"[98] then § 542(a) is the appropriate turnover provision. If the secured party has obtained a receiver to collect rents, § 543 enjoys the honor of jurisdiction.[99]

Some courts hold that the parties to a mortgage can defeat a trustee's turnover power by agreeing to an absolute assignment of rents. The idea is that the debtor owns no property rights in rent receivables once default occurs. According to § 542(a), turnover depends upon "property that the trustee may use, sell, or lease under section 363."[100] Section 363, in turn, authorizes the trustee to use "property of the estate"[101] or "cash collateral."[102] Cash collateral is defined as highly liquid collateral "in which the estate and an entity other than the estate have an interest."[103] If a custodian has been appointed to collect rents, § 543(b) requires that the custodian be in charge of the "property of the debtor."[104]

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97. *E.g.*, *In re* Newberry Square, Inc., 175 B.R. 910 (Bankr. E.D. Mich. 1994) (Shaper, J.); *In re* Bethesda Air Rights, 117 B.R. at 209-21; *In re* Mews Assocs., 144 B.R. 867, 871 (Bankr. W.D. Mo. 1992) (Federman, J.) (applying Missouri law).

98. A custodian is defined in § 101(11) of the Bankruptcy Code as

> (A) receiver or trustee of any of the property of the debtor, appointed in a case or proceeding not under this title;
>
> (B) assignee under a general assignment for the benefit of the debtor's creditors; or
>
> (C) trustee, receiver, or agent under applicable law, or under a contract, that is appointed or authorized to take charge of property of the debtor for the purpose of enforcing a lien against such property, or for the purpose of general administration of such property for the benefit of the debtor's creditors.

11 U.S.C. § 101(11) (Supp. V 1993).

99. *E.g.*, *In re* Cadwell's Corners Partnership, 174 B.R. 744, 755-56 (Bankr. N.D. Ill. 1994) (Katz, J.) (Illinois law) (but refusing turnover where property was not necessary for an effective reorganization); *In re* Donato, 170 B.R. 247, 256-57 (Bankr. D.N.J. 1994). Section 543 allows for discretionary abstention by the bankruptcy court when it would serve the best interest of the creditors. *In re* LCL Income Props. L.P. VII, 177 B.R. 872 (Bankr. S.D. Ohio 1995) (excusing mortgagee's receiver on this ground); *In re* Constable Plaza Assocs., 125 B.R. 98, 103-04 (Bankr. S.D.N.Y. 1991) (Schwartzber, J.).

Turnover is an innovation of the Bankruptcy Code. *See* United States v. Whiting Pools, Inc., 462 U.S. 198, 206 n.13 (1983) (Blackmun, J.); Investors Syndicate v. Smith, 105 F.2d 611, 621 (9th Cir. 1939).

100. 11 U.S.C. § 542(a) (1988).

101. 11 U.S.C. § 363(b)(1) (1988); 11 U.S.C. § 363(c)(1) (1988), *as amended by* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, sec. 501(b)(8) (B), § 363(c)(1), 108 Stat. 4106, 4144 (1944).

102. 11 U.S.C. § 363(c)(2) (1988).

103. 11 U.S.C. § 363(a) (1988), *as amended by* Bankruptcy Reform Act. of 1994, Pub. L. No. 103-394, sec. 214(b), § 363(a), 108 Stat. 4106, 4126 (1994).

104. *Cf.* 11 U.S. § 543(b) (1988) (requiring the custodian to deliver the debtor's property to

If the absolute assignment leaves the debtor with no property rights in the rent receivables, then the trustee's turnover cause of action under either § 542(a) or § 543(b) is defeated.[105]

This theory can be traced to some imprecise and frequently misread language in *Kinnison v. Guaranty Liquidating Corp.*,[106] where Chief Justice Phil S. Gibson wrote:

> The agreement between the parties . . . either by a clause inserted in the deed of trust or mortgage or by a separate instrument, may provide that in the event of default the rents are assigned absolutely to the mortgagee. It has been held that such a provision, rather than pledging the rents as additional security, operates to transfer to the mortgagee the mortgagor's right to the rentals upon the happening of the specified condition.[107]

One is tempted to conclude that this passage is simply a clumsy way of expressing the idea that the parties are free to terminate by contract the debtor's right to collect rents free and clear of the security interest before dispossession of the debtor. Unfortunately, other passages in this opinion make such a conclusion doubtful. In *Kinnison* a debtor had defaulted on an earlier standard mortgage. Therefore, the parties renegotiated. In the new agreement, the debtor could collect rents, but only as agent of the secured party. These collections found their way into a bank account in the name of the debtor when a judgment creditor garnished the bank, and the bank paid the garnishor. The secured party thereafter successfully sued the garnishor for converting the secured party's property.[108]

The *Kinnison* opinion does not set forth the exact factual situation, but it appears as if the mortgage was substantially underwater, and the rents actually collected by the debtor were not part of any debtor surplus. Justice Gibson probably should have ruled that the secured party had a superior lien on the rents collected. The judicial lien creditor had only a junior lien, and when the judicial lien creditor interfered with the secured party's dominion, it committed the tort of conversion against the secured party. This holding would have protected the senior secured party while adhering to the idea that the secured

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the trustee and to file an accounting of the debtor's property).

105. The *debtor* in a recent case argued that the mortgage agreement created an absolute assignment of this sort. Kansas had just enacted a U.C.C.-style statute with regard to proceeds of rent receivables. Because the statute covered only liens, the debtor argued that an absolute assignment was not covered and must be perfected to be valid in bankruptcy. Judge Julie Robinson found, however, that the assignment was a lien, and that the new statute applied. *In re* Kansas Office Assocs., 173 B.R. 745, 749 (Bankr. D. Kan. 1994).

106. 115 P.2d 450 (Cal. 1941).

107. *Id.* at 453 (citations omitted).

108. *Id.* at 451-52.

party had only a security interest in the receivables in question. But Justice Gibson went much further:

> Such an assignment cannot be said to have contemplated the transfer of a mere security interest. The instrument is phrased as a complete transfer of [the debtor's] interest in the rentals. Thus, there is no provision for a continued enjoyment of the rents by the debtor so long as no default exists in the obligation secured. Nor is there any indication that, by meeting the obligations then due, [the debtor] could have regained its right to receive the rents. Rather, the rents were relinquished completely, to be applied . . . in satisfaction of the total outstanding indebtedness. This was not an assignment as further security for the performance of [the debtor], but was an attempt to liquidate the debt upon which [the debtor] had been in default for at least eight months at the time the assignment was executed. Unlike the rental assignments accompanying the deeds of trust executed in 1928 and 1932, this assignment contemplated an immediate application of the rentals as a means of satisfying the total outstanding debt.[109]

Apparently, when the debtor defaulted under the earlier mortgage agreement, the debtor and the secured party entered into a deed in lieu of foreclosure. This deed made the secured party the absolute owner of the rent receivables. Only then can it be said that the rent receivables reduced the outstanding debt upon assignment and that the debtor had no right to collect these rent receivables once the secured claim had been totally paid off. In short, Justice Gibson treated *Kinnison* as an "asset payment" case, in which the mortgage debt was reduced by the appraised value of the receivables, and the secured party became the absolute owner of the receivables. In other words, the deal describe by Justice Gibson is a sale of, not a security interest on, rent receivables.[110]

The "sale" of a rent receivable is certainly a possible form of property transfer. If the agreement is reached in the context of a pre-existing default on an earlier mortgage agreement, it might be a mode of paying the secured claim. But the parties cannot agree that all rent receivables are to be deemed as sold or forfeit immediately upon default. Such a forfeiture is precisely what medieval equity courts intervened to prevent.[111] Instead, any predefault

109. *Id.* at 454.

110. *See* Rogers, *supra* note 53, at 1449. From his perspective as a state supreme court justice, Gibson had no particular reason to focus on the difference between the secured party's exclusive ownership of a rent receivable and the secured party's shared ownership with the debtor. Justice Gibson's sole concern was to determine the recipient of the money. Only in bankruptcy (which after 1979 had a suddenly increased turnover provision) did this distinction matter. *See supra* text accompanying notes 19-20. Because the legal landscape of bankruptcy has changed so radically, it is odd that so much weight is put on a distinction made by Justice Gibson that was utterly unimportant to him at the time.

111. *See In re* Growers Properties No. 56 Ltd., 117 B.R. 1015, 1015-16 n.1 (Bankr. M.D.

forfeiture agreement would be treated as if it were a security interest, regardless of the parties' intent. Despite the confusing terminology, an absolute assignment governs merely the duration of the debtor's right to collect free and clear of the security interest. An absolute assignment does not change the fact that the debtor owns an equity interest in the receivables.[112]

Under this theory, absolute assignment, when used in a security agreement, implies merely that the debtor's right to collect rents may be terminated automatically upon the occurrence of an event of default[113] or by notifying the tenants that they are to pay the secured party directly.[114] Other courts think that the phrase invokes a U.C.C.-style of rule with regard to rent proceeds. Judge Emil Goldhaber, articulating New Jersey law, stated:

> [T]he distinction between an assignment and a pledge of security is based on the precise wording of the pertinent mortgage clause. If the pertinent clause gives the mortgagee a vested interest in the rents at the time of the creation of the mortgage, the clause is construed as an assignment. Who has actual or constructive possession of the rents is irrelevant. The applicable mortgage provision is deemed a pledge of security if the mortgagee's interest in the rents does not vest until the occurrence of some precipitating event such as default under the mortgage.[115]

Fla. 1990) (Baynes, J.) (stating that this approach "would create a forfeiture within the lien context without a judicial foreclosure which is required by Florida law.").

112. *See, e.g.*, FDIC v. Int'l Prop. Mgt., Inc., 929 F.2d 1033, 1037 (5th Cir. 1991) (King, J.) (applying Texas law) (concluding that the assignment of rents was "to assure payment of the debt"); Equitable Mortgage Co. v. Fishman (*In re* Charles D. Stapp, Inc.), 641 F.2d 737, 740 (9th Cir. 1981) (construing Nevada law as follows: 'Absolute' does not mean . . . that the assignee is relieved of all obligation to account or that the right to rents is independent of the underlying debt. Upon foreclosure, the creditor . . . must account for any excess derived from the sale and rents collected between the date of default and the date of foreclosure sale over and above the amount of the obligation owed.); *In re* Cadwell's Corners Partnership, 174 B.R. 744, 755-56 (Bankr. N.D. Ill. 1994) (Katz, J.) (Illinois law); 5028 Wisconsin Ave. Assocs. v. Copy King, Inc. (*In re* 5028 Wisconsin Ave. Assocs.), 167 B.R. 699, 705 & n.8 (Bankr. D.D.C. 1994); *In re* May, 169 B.R. 462, 470-71 (Bankr. S.D. Ga. 1994) (applying Georgia law); *In re* Willows of Coventry, Ltd. Partnership, 154 B.R. 959, 962-63 (Bankr. N.D. Ind. 1993) (applying Indiana law); Shaw, Licitra, Parente, Esernio & Schwartz, P.C. v. Travelers Indem. Co. (*In re* Grant Assocs.), 154 B.R. 836, 838 (Bankr. S.D.N.Y. 1993) (Fleeh, J.); *In re* Mews Assocs., 144 B.R. 867, 870 (Bankr. W.D. Mo. 1992) (Mes, J.) (applying Missouri law); *In re* Salem Plaza Assocs., 135 B.R. 753, 756 (Bankr. S.D.N.Y. 1992) (Conard, J.) (applying North Carolina law); *In re* Constable Plaza Assocs., 125 B.R. 98, 102-03 (Bankr. S.D.N.Y. 1991) (Schwartzberg, J.).

113. *See* Wolters Village, Ltd. v. Village Properties, Ltd. (*In re* Village Properties, Ltd.), 723 F.2d 441, 443 (5th Cir. 1984) (Garza, J.) (applying Texas law), *cert. denied*, 466 U.S. 974 (1984); *In re* May, 169 B.R. at 467.

114. Union Meeting Partners v. Lincoln Nat'l Life Ins. Co. (*In re* Union Meeting Partners), 163 B.R. 229, 236-37 (Bankr. E.D. Pa. 1994) (School, J.); *see* TENN. CODE ANN. § 66-26-116(a) (1993).

115. Provident Mut. Life Ins. Co. v. Winslow Ctr. Assocs. (*In re* Winslow Ctr. Assocs.), 50

So conceived, the mortgage becomes the "vifgage"—the medieval device allowing the lender to control the cash flow from the beginning of the term.[116] Under these terms, the absolute assignment is not absolute, but is conceived as a different form of security interest.[117]

Nevertheless, judges routinely have authorized forfeitures upon default based upon their reading of *Kinnison*.[118] In *Great West Life Assurance Co. v. Rothman (In re Ventura-Louise Properties)*[119] the secured party had notified all of the debtor's tenants that they should pay rents to the secured party in light of the debtor's default. The debtor soon responded with a bankruptcy petition. The bankruptcy trustee notified the tenants that they should pay the trustee, not the secured party. The parties agreed that the bankruptcy trustee could collect rent, but ownership of the rent would be decided later by the bankruptcy referee. No reorganization was possible, so the bankruptcy trustee eventually abandoned the real estate.[120] Judge Stanley Barnes properly ruled that the secured party was the owner of the collected rents.[121]

In modern parlance, we might say that in *Ventura-Louise* the collected rents were cash collateral that ought to be abandoned to the secured party because there was no prospect of reorganization and because the debtor had no equity in the cash collateral.[122] Instead, Judge Barnes decided that the secured party should win by virtue of the absolute assignment of the rents, believing this transaction to be the same kind of absolute assignment that existed in *Kinnison*.[123]

B.R. 679, 681 (Bankr. E.D. Pa. 1985) (citations omitted).

116. *See In re* 1301 Connecticut Ave. Assocs., 117 B.R. 2, 8 (Bankr. D.D.C. 1990) (Teel, J.), *aff'd* 126 B.R. 1 (Bankr. D.D.C. 1991). (applying District of Columbia law) (drawing this connection). For a description of vifgage, see generally August v. Michigan Ave. Nat'l Bank (*In re* Michigan Ave. Nat'l Bank), 2 B.R. 171, 176-77 (Bankr. N.D. Ill. 1980) (Merrick, J.).

117. *See* FDIC v. International Property Management, Inc., 929 F.2d 1033, 1036-38 (5th Cir. 1991) (King, J.); *In re* Bethesda Air Rights Ltd. Partnership, 117 B.R. 202, 206 (Bankr. D. Md. 1990) (Derby, J.).

118. *E.g.*, Eastern Savs. Bank v. Epco Newport News Assocs. (*In re* Epco Newport News Assocs.), 14 B.R. 990 (Bankr. S.D.N.Y. 1981) (Ryan, J.) (applying Virginia law).

119. 490 F.2d 1141 (9th Cir. 1974).

120. *Id.* at 1142-43.

121. *See id.* at 1145.

122. *Cf.* 11 U.S.C. § 362(d)(2) (1988) (providing that "the court shall grant relief from the stay" in such circumstances).

123. Thus, Judge Barnes writes:

> We therefore agree with the court in *Kinnison* which said: "In the present case we do not see how it can be said that the parties contemplated merely the transfer of a security interest in the rentals."
>
> We hold that the present clause provides for an absolute assignment thus entitling the Lender to the rents.

The opinion is consistent with the far more modest and supportable definition of absolute assignment—that it governs the moment at which the debtor's power to disencumber rents comes to an end. Under this view, the right to collect rents, if useful to a reorganization, would be fully subject to a trustee's right of turnover under § 542(a), which in turn would be conditioned upon adequate protection to the security interest on the rent receivables.[124]

Another oft-quoted misstatement, relying exclusively on *Kinnison* and *Ventura-Louise*, comes from *Taylor v. Brennan*,[125] in which Justice Sears McGee opined that "an absolute assignment of rentals operates to transfer the right to rentals automatically upon the happening of a specified condition, such as default. The absolute assignment does not create a security interest but instead passes title to the rents."[126]

This careless language, copied from California law, was harmless error in the *Taylor*; Justice McGee found that the debtor had the right to collect rents free and clear of the security interest and, therefore, was innocent of converting property of the mortgagees. But the statement has created havoc in the bankruptcy courts, where judges now believe that under *Butner v. United States*[127] they must look to state law, however demented, to determine bankruptcy entitlements.

A more sensible reading of the *Kinnison-Taylor* line of cases is provided by Judge Carolyn Dineen King in *FDIC v. International Property Management, Inc.*,[128] in which the secured party sought an injunction to prevent the debtor's managing agent from disbursing collected rents to unsecured creditors. The injunction was properly granted, and in affirming this result, Judge King expressed concern that *Taylor v. Brennan* seemed to support the idea of forfeitures of rent receivables to secured parties upon default:

> The *Taylor* court could have recognized that all assignments in connection with a mortgage are to secure the debt, as they undoubtedly are, and then taken one of two approaches to such clauses. It could have followed the common law rule and required a mortgagee always to take some step to perfect its interest in rents following default; or it could have decided that it would not follow the common law rule when the parties

Ventura-Louise, 490 F.2d at 1145 (quoting Kinnison v. Guaranty Liquidating Corp., 115 P.2d 450, 453 (Cal. 1941).

124. *See* 11 U.S.C. § 363(e) (1988). For what constitutes adequate protection see *infra* text accompanying notes 165-72.

125. 621 S.W.2d 592 (Tex. 1981).

126. *Id.* at 594 (citations omitted).

127. 440 U.S. 48 (1979) (Stevens, J.). For further discussion, see *supra* text accompanying notes 43-53.

128. 929 F.2d 1033 (5th Cir. 1991).

sufficiently evidence their intent that the right to rents should pass automatically upon default. Texas, however, adopted neither of these straightforward alternatives. Rather, it decided that certain assignments of rents given in connection with a mortgage and contingent upon default constitute title transfers rather than "security interests."[129]

Judge King denied the premise that these forfeitures were not, in the end, security interests:

> Whatever terminology the court uses, however, mortgagees employ such assignments to secure the debt, and all such assignments would be considered security interests under the Uniform Commercial Code (U.C.C.), which treats all transfers intended to secure a debt as security interests despite their form.
>
> Article 9 does not apply, however, to the "creation or transfer of an interest in or lien on real estate, including a lease or rents thereunder," and the concept of a contingent present assignment of rents apparently derives from real property and trust concepts rather than the U.C.C. That the economic reality underlying absolute assignment of rents is the desire to assure payment of the debt did not prevent the *Taylor* court from acknowledging that some collateral assignment of rent clauses operate "to transfer rents automatically upon default" without being "activated by some affirmative act" by the mortgagee. In fact, the principal case cited by the *Taylor* court as an example of an absolute assignment [*i.e.*, *Ventura-Louise*] contains a clause that only can be construed as intended to assure payment of the debt. Such contingent present assignments allow the parties to a mortgage to agree to an assignment that gives the mortgagee an immediate right to rents upon default. In effect, Texas allows the parties to a mortgage to agree that the mortgagee has a right to rents immediately upon default through use of the concept of a present transfer of title with enjoyment deferred until default.[130]

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129. *Id.* at 1035.

130. *Id.* at 1035-36 (citations and footnotes omitted). In one of the footnotes in this passage, Judge King writes:

> A contingent present assignment immediately transfers legal title to rents to the mortgagee but the mortgagor continues to enjoy the rents until the occurrence of a specified condition-usually default. Upon the occurrence of the specified condition, the mortgagee receives the right to enjoy the rents (in addition to the legal title he already possessed). This theory appears based on trust concepts, but the Texas courts have not elaborated on this theoretical underpinning.

Id. at 1035 n.2. Actually, it can be said more definitively that the so-called Texas law of absolute assignment comes entirely from a misreading of *Kinnison*—a California case. The theory does not come from "trust concepts" at all.

Because the parties had agreed that the debtor's power to collect rents free and clear of the security interest on rent receivables should terminate upon default, Judge King had no trouble affirming the injunction that prevented the debtor's managing agent from dissipating the secured party's collateral. This affirmance did not require a finding that the debtor had forfeited all equity interest in rent receivables to the secured party.

From the above misreadings of *Kinnison* has come the extreme position that the bankruptcy trustee has no turnover right if the mortgage agreement contains an absolute assignment of rents.[131] This is because the secured party has become the absolute owner of the real estate receivables, not merely the secured party of the receivables.[132] Accordingly, the real estate receivable, upon default, is to be forfeited temporarily to the secured party. As soon as the secured claim is paid, the receivables revert automatically to the debtor.[133]

In *Commerce Bank v. Mountain View Village, Inc.*[134] a mortgagee had seized control of the rents and had been collecting them for more than ninety days by the time of the bankruptcy petition. After the Chapter 11 petition had been filed, the debtor-in-possession sought to re-establish its right to collect rents.[135] Judge Joseph Weis ruled that the debtor had no property interest in the rents because Pennsylvania law followed the title theory.[136] In so ruling,

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131. *See id.* at 595.

132. Whether an absolute assignment of rents is intended is often thought to turn on whether the contract describes the assignment as "additional security." If such language appears, the assignment is not absolute. *See, e.g., In re* Mocco, 176 B.R. 355, 341-42 (Bankr. D.N.J. 1995) (Gindin, J.); *In re* Association Ctr. Ltd. Partnership, 87 B.R. 142, 144-46 (Bankr. W.D. Wash. 1988) (Steiner, J.). But, given that absolute assignments are still security interests, such linguistic examinations are pointless.

A better standard is whether the agreement manifests an intent to terminate the debtor's right to collect rents at some agreed-upon time. In *Association Center*, such an intent was clear, *see id.* at 143; thus, the absolute assignment should have been recognized—as a security interest.

133. *In re* Union Meeting Partners, 160 B.R. 757, 767 (Bankr. E.D. Pa. 1993) (Scholl, J.) (stating "thus, *Mountain View* effectively provides a mortgagee with either an ownership interest in rents which expires when the mortgagee's claim is paid in full or an absolute assignment of the rents for a limited duration."); *compare* Steven L. Schwarcz, *The Parts Are Greater Than the Whole: How Securitization of Divisible Interests Can Revolutionize Structured Finance and Open the Capital Markets to Middle-Market Companies*, 1 COLUM. BUS. L. REV. 139 (1993) (arguing similar arrangements are possible under Article 9 of the U.C.C.).

134. 5 F.3d 34 (3d Cir. 1993) (Weis, J.).

135. As described by the court, the debtor-in-possession "asserted its right to use the rents as cash collateral in its reorganization plan." *Id.* at 35-36. Apparently, the debtor was seeking a turnover of rents under § 542(a). *See id.* at 38-39 (citing United States v. Whiting Pools, Inc., 462 U.S. 198 (1983)).

136. *Commerce Bank*, 5 F.3d at 39 ("We find no indication that Pennsylvania has veered from its longstanding title theory to one treating mortgages as security interests."). A similar claim was made with regard to wage garnishments in Riddervold v. Saratoga Hosp., (*In re* Riddervold),

Judge Weis implied that, by terminating the debtor's right to collect, the secured party's lien was changed into an absolute interest in the rents: "[B]y entering the property and collecting the rents, the banks were 'enforcing' their rights, not 'perfecting' their liens. The banks' liens arose when the mortgages were recorded. Liens arising at a later date would be junior to that of the banks."[137]

This passage recognizes that the right to collect rent was a lien prior to the seizure of the right to collect. After the absolute assignment became effective, the lien was no longer a lien. Debtor equity had been forfeited upon default—precisely the medieval forfeiture that equity intervened to prevent so many centuries ago.[138]

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647 F.2d 342 (2d Cir. 1981). In *Riddervold*, a creditor garnished wages before the voidable preference period. *Id.* at 343. Judge Henry Friendly ruled that no voidable preferences had been received. He found that when the wages were garnished, the judicial lien creditor had received an absolute assignment of wages prior to the preference period, rather than a mere lien. *Id.* at 346-47. This position cannot be sustained; it implies that if the debtor were to pay off the debt owed to the judicial lien creditor, the judicial lien creditor could go on collecting the debtor's wages in perpetuity. Obviously, if the judicial lien creditor was paid off, the lien on wages would disappear. In other words, the creditor could only claim a lien, not an absolute assignment of wages.

Nevertheless, *Riddervold* was rightly decided for a different reason: The garnishment encumbered an executory contract prior to the preference period and, was thus immune from avoidance. *See* Susan J. Samuels, Note, *Garnishment Payments: Voidable Preferences in Bankruptcy?*, 7 CARDOZO L. REV. 309, 316-31 (1985).

137. *Commerce*, 5 F.3d at 39.

138. For other cases following this reasoning, see *In re* Glen Properties, 168 B.R. 537 (Bankr. D.N.J. 1993) (Debevoise, J.) (New Jersey law); *In re* Gould, 78 B.R. 590 (Bankr. D. Idaho 1987) (Taylor, J.); *In re* Woodmere Investor, Ltd. Partnership, 178 B.R. 346, 358-61 (Bankr. S.D.N.Y. 1995) (Blackstein, J.) (Michigan law); *In re* Donato, 170 B.R. 247, 252-54 (Bankr. D.N.J. 1994) (Ferguson, J.); *In re* South Pointe Assocs., 161 B.R. 224 (Bankr. E.D. Mo. 1993) (Barta, J.); *In re* Mount Pleasant Ltd. Partnership, 144 B.R. 727, 734-37 (Bankr. W.D. Mich. 1992) (Stevenson, J.); Imperial Gardens Liquidating Trust v. Northwest Commons, Inc. (*In re* Northwest Commons, Inc.), 136 B.R. 215 (Bankr. E.D. Mo. 1991) (Schermer, J.); *In re* Fry Road Assocs., Ltd. 64 B.R. 808 (Bankr. W.D. Tex. 1986) (Ayers, J.); *In re* P.M.G. Properties, 55 B.R. 864 (Bankr. E.D. Mich. 1985) (Brody, J.).

In *In re* Tripplet, 84 B.R. 84 (Bankr. W.D. Tex. 1988), Judge Glen Ayers modified his holding in *Fry Road* by finding absolute assignments to be security interests in rent receivables and by pointing out that *Fry* involved special instances of estoppel and waiver. *See id.* at 87 & n.2 (citation omitted).

Similarly, a recent Florida statute has been interpreted to create an absolute assignment of the sort instituted by *Mountain View Village*. According to this statute:

> A mortgage may provide for an assignment of rents. If such assignment is made, such assignment shall be absolute upon the mortgagor's default, becoming operative upon written demand made by the mortgagee. Upon application by the mortgagee, a court of competent jurisdiction may require the mortgagor to deposit such rents in the registry of the court pending adjudication of the mortgagee's right to the rents, any payments therefrom to be made solely to protect the mortgaged property and meet

Under such a holding, reorganization is impossible in any real estate case unless the debtor-in-possession is willing to cover all expenses of the reorganized entity with new equity contributions while the secured party milks the rents. Thus, in *In re Union Meeting Partners*[139] Judge David Scholl found that "none of the Rents can be used by the Debtor in conjunction with the Plan, even if they are used only to pay for the reasonable expenses of operating the Property."[140] Instead, "the Debtor was relegated to either having its General Partners fund the costs of operation throughout the term of the Plan, or somehow regaining control of all or part of the Rents."[141]

> the mortgagor's lawful obligations in connection with the property. Any undisbursed portion of said rents shall be disbursed in accordance with the court's final judgment or decree.

FLA. STAT. ANN. § 697.07 (West 1994). For cases finding that this statute successfully excludes rent receivables from the bankrupt estate, see *In re* Thymewood Apartments, Ltd., 123 B.R. 969, 973 (Bankr. S.D. Ohio 1991) (Kinneary, J.); *In re* Carter, 126 B.R. 811, 813 (Bankr. M.D. Fla. 1991) (Proctor, J.); *In re* Sunrise Indus. Dev. Corp., 121 B.R. 911 (Bankr. S.D. Fla. 1990) (Weaver, J.); *In re* Growers Properties No. 56 Ltd., 117 B.R. 1015, 1016 n.1 (Bankr. M.D. Fla. 1990) (Baynes, J.); *In re* 163rd St. Mini Storage, Inc., 113 B.R. 87 (Bankr. S.D. Fla. 1990) (Weaver, J.).

For cases that deny the statute has any such effect, see *In re* Gorrow Dev. Corp., 135 B.R. 427, 429-30 (Bankr. M.D. Fla. 1991) (Baynes, J.); *In re* Mariner Enters., 131 B.R. 190, 192 (Bankr. N.D. Fla. 1989) (Killian, J.); *In re* One Fourth St. N., Ltd., 103 B.R. 320, 322 (Bankr. M.D. Fla. 1989) (Paskay, J.); *In re* Aloma Square, Inc., 85 B.R. 623, 625 (Bankr. M.D. Fla. 1988) (Proctor, J.), *aff'd*, 116 B.R. 827 (M.D. Fla. 1990) (applying statute retroactively, but finding that the meaning of the statute was to give the secured party only a security interest in rent receivables).

Some recent state cases have supported the view that the Florida legislation does not create a new forfeiture of rent receivables and assert that the legislation is only procedural in nature, affecting the time at which the debtor's right to collect rents free and clear of the mortgage lien has finally terminated. *See* Oakbrooke Assocs., Ltd. v. Insurance Comm'r, 581 So.2d 943 (Fla. Dist. Ct. App. 1991)(Dauksch, J.); Nassau Square Assocs., Ltd. v. Insurance Comm'r, 579 So.2d 259 (Fla. Dist. Ct. App. 1991) (per curiam).

Judge Suzanne Conlon, in *In re* VIII South Michigan Associates, 145 B.R. 912 (N.D. Ill. 1992), ruled as a matter of Illinois law that rent receivables were completely forfeit once a receiver was appointed, but she relied on dictum from *In re* Century Investment Fund VIII Ltd. Partnership, 937 F.2d 371, 377-78 (7th Cir. 1991) (Jones, J.) ("Once bankruptcy is filed, the debtor has the right to the use of the rental proceeds only if the security interests were not perfected under state law"). The issue in *Century Investment* was strictly whether a security interest on rent receivables was perfected not whether proceeds of the receivables were cash collateral. Therefore, Judge Erwin Katz thought that the higher court in *VIII South* might Safely be ignored. *In re* Cadwell's Corners Partnership, 174 B.R. 744, 756-58 (Bankr. N.D. Ill. 1994).

139. 165 B.R. 553 (Bankr. E.D. Pa. 1994).

140. *Id.* at 556. Judge Scholl has also ruled that cash collateral stipulations agreed to by the secured party do not waive the secured party's right to assert its absolute assignment theory. *In re* Union Meeting Partners, 160 B.R. 757, 766 (Bankr. E.D. Pa. 1993).

141. *Meeting Partners*, 165 B.R. at 557.

The debtor in *Union Meeting Partners* argued that Pennsylvania law does not allow a mortgagee to take possession of encumbered real estate, pocket the rents, and then let the property deteriorate. Rather, the mortgagee has a duty to use the rents to maintain the property and to pay down the secured claim with net rents only.[142] Judge Scholl, however, ruled that state law no longer governed:

> [w]e are bound by the decision in *Mountain View* which holds that a mortgagee which has properly recorded its assignment of rents and has made appropriate demand upon the tenants for payment of rents to it pre-petition holds title to the rents which the debtor may not use to fund a plan of reorganization.[143]

The alpine view, then, implies that mortgagees are free to milk property by keeping gross rents. Ironically, rent assignments have been justified by the fear that unscrupulous debtors would milk real estate rents and let the property run down.[144] Yet, holdings like *Mountain View* invite the secured party to do the very thing it was feared debtors would do.

Thus, *Mountain View*, originally intended to survey the law of Pennsylvania, has become a law unto itself. State law has been overridden even though the *Mountain View* court held that, under *Butner v. United States*,[145] a bankruptcy court must apply state law with regard to security interests on rent.[146]

A series of tests prove that the perception of absolute assignment is false. Each test shows that the debtor retains a property interest in rent receivables, even after the debtor's power to collect rents has terminated.

First, assume that under an absolute assignment of rents a debtor has lost the right to disencumber a security interest on rents by collecting. The secured party, however, claims several pieces of collateral. Some other piece of collateral is sold, and the proceeds are enough to pay the mortgage debt entirely. What happens to the rent in which the secured party is supposed to have absolute ownership? Theoretically, the secured party may continue to

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142. Indeed this very obligation has been taken to mean that absolute assignments are security interests after all. *See infra* notes 151-52.

143. 165 B.R. at 564 (footnote omitted).

144. *See* James McCafferty, *The Assignment of Rents in the Crucible of Bankruptcy*, 94 COM. L.J. 433, 437 (1989); Note, *supra* note 91, at 1424 & n.1.

145. 440 U.S. 48 (1979).

146. Commerce Bank v. Mountain View Village, Inc., 5 F.3d 34, 37-38 (3d Cir. 1993). Judge Scholl subsequently expressed "some misgivings regarding the soundness of *Mountain View* holdings" and stated that "[the court is] not convinced that the repercussions it will have on single asset [bankruptcies] are, on balance, fair to all players in the bankruptcy system." Union Meeting Partners v. Lincoln Nat'l. Life Ins. Co. (*In re* Union Meeting Partners), 163 B.R. 229, 235 (Bankr. E.D. Pa. 1994).

collect rent even after the debt is paid in full. But such a view is untenable. Instead, courts allow the receivable to revert to the debtor.[147] This proves that the debtor retained an interest in the receivable. Since the receivable is rife with debtor equity, it is part of the bankrupt estate under § 541(a)(1) and, therefore, can be used under § 363.[148]

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147. Judge King described an absolute assignment as follows:

> [The debtor] contends that the . . . assignment of rents . . . [was] included . . . to provide additional protection upon default. We agree. The provisions in the assignment of rents clause that allow the mortgagor to receive rents until default . . . , that require the mortgagee to apply rental income to the debt (with any remainder going to the mortgagor), and that provide for termination of the assignment of rents on release of the deed of trust would be unnecessary were the clause not intended to assure payment of the debt.

FDIC v. International Property Management, Inc., 929 F.2d 1033, 1037-38 (5th Cir. 1991) (footnotes omitted).

148. *In re* Mocco, 176 B.R. 355, 344-45 (Bankr. D.N.J. 1995) (Gordon, J.) (debtor owned the right to redeem rent receivables); *In re* Hall Elmtree Assocs., 126 B.R. 73, 75 (Bankr. D. Ariz. 1991) (Ollason, J.) (applying Virginia law), *dismissed in part and rev'd in part*, 139 B.R. 571 (Bankr. 9th Cir. 1991). Judge Jo Ann Stevenson, who thought that a debtor has no equity interest in rents after default (if the agreement provides for an "absolute assignment"), rather too quickly remarked:

> As the illustration demonstrates, once default occurs a role reversal of sorts takes place. The mortgagor now has an "inchoate" right to future rents, based on the uncertain possibility that the property will be redeemed . . . . The interest which the mortgagor has does not entitle him to payment of current rents even if he realizes on his inchoate right of redemption. These rents have slipped forever from his grasp, and bankruptcy cannot change this fact. To interpret *Whiting Pools* so broadly as to *never* permit the debtor's rights in rents to terminate would effectively overrule *Butner*; no matter what state law provided, a mortgagor could never become entitled to receive rent payments once bankruptcy intervened.

In re Mount Pleasant Ltd. Partnership, 144 B.R. 727, 738 (Bankr. W.D. Mich. 1992) (Stevenson, J.). "Role reversal" and the debtor's inchoate right to rent actually defeat Judge Stevenson's argument and prove that the debtor has an equity interest in rent receivables. Stevenson confuses matters by apparently referring to the principle that, once a mortgagee collects rents and applies them to the mortgage debt the debtor's equity interest disappears. This is true (putting aside voidable preference law for the moment). But the issue is the whether the debtor has an interest in *rent receivables* that have not yet been collected. Stevenson involuntarily admits that the debtor has an equity interest in the rent receivables.

In *In re* South Pointe Assocs., 161 B.R. 224 (Bankr. E.D. Mo. 1993), Judge James Barta held that a debtor owns surplus in rents only after the secured claim is entirely paid. The rest is owned by the secured party outright. But Barta does not apply the test suggested in the text, which shows that the secured party and the debtor generally are covenants to any given rent receivable, until the secured party collects rents and applies them to the mortgage debt.

Two commentators assert that Florida has made all rent assignments "absolute" in that they are not mere security interests in rent receivables. Donahue & Edwards, *supra* note 54, at 657. Close examination of the Florida legislation shows that this view is untenable. The provision does say that "such assignment shall be absolute," but it also indicates that the debtor owns an interest in rents after the mortgage debt is paid. FLA. STAT. ANN. § 697.07 (West 1994). Therefore, an "absolute assignment" in Florida remains a mere security interest.

Second, suppose that after a debtor's right to collect rent has terminated, the tenant defaults on the obligation to a secured party who holds an absolute assignment. Does the secured party have recourse against the debtor or the debtor's property for that which the tenant has failed to pay?[149] If recourse exists, the receivable is only collateral for the secured claim. If the secured party owned the receivable absolutely, the assignment would constitute an asset payment that extinguished the secured claim. The secured party would then assume the risk that the tenant might not pay the rent due. Yet it is very doubtful that an absolute assignment constitutes an asset payment.[150]

A third test, suggested by Judge Steven Rhodes, is whether the secured party is restricted by state law to use rent proceeds on the maintenance of the real estate—a common requirement. "Presumably," he wrote, "if the rents are the exclusive property of the mortgagee, it can do with the rents as it wishes."[151] As the mortgagee commonly is required to spend proceeds of rent receivables on property maintenance prior to satisfying the mortgage debt, Judge Rhodes's test proves that absolute assignments are, in essence, security interests.[152]

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149. A nonrecourse estate mortgage requires a reformulated test: if a tenant defaults, would the nonrecourse mortgagee have an unsecured artificial recourse claim under § 1111(b)(1)(A) or would assignment of the rent receivable absolutely extinguish the mortgage debt?

150. *Accord*, 500 Ygnacio Assocs. v. Aetna Life Ins. Co. (*In re* 500 Ygnacio Assocs.), 141 B.R. 191, 195 (Bankr. N.D. Cal. 1992); *In re* Tripplet, 84 B.R. 84, 88 (Bankr. W.D. Tex. 1988) (Ayers, J.); Forrester, *supra* note 5, at 380-82. *But see In re* Fry Road Assocs., 64 B.R. 808, 809 n.1 (Bankr. W.D. Tex. 1986) (Ayers, J.) ("if title was transferred, a portion of the debt . . . has obviously been discharged or paid *pro tanto*.") (citation omitted).

151. *In re* Coventry Commons Assocs., 134 B.R. 606, 610 (Bankr. E.D. Mich. 1991), *rev'd on other grounds*, 143 B.R. 837 (E.D. Mich. 1992).

152. *In re* Gorrow Dev. Corp., 135 B.R. 427, 429 (Bankr. M.D. Fla. 1991) (Baynes, J.) (finding that rent receivables were part of the bankrupt estate on this basis); accord *In re* One Fourth St. N., Ltd., 103 B.R. 320, 322 (Bankr. M.D. Fla. 1989) (Paskax, J.). This test, however, was rejected by Judge Jo Ann Stevenson:

> The interest [of the debtor in forcing the mortgagee to maintain the property] is nothing more than the right any debtor has to see that payments made or collateral liquidated are applied to the indebtedness. While the mortgagee is under a duty to use the rents to preserve its collateral and may be required to make expenditures to that end, the debtor has no interest in the actual payments made or the collateral liquidated. The debtor's right is analogous to the right of a debtor whose vehicle was repossessed and sold to have the sale proceeds applied to her loan. This right does not give her the right to demand that the bank return her car. The only distinction is that in the case of an assignment of rents the collateral executed upon and liquidated is an income stream rather than a physical object.

In re Mount Pleasant Ltd. Partnership, 144 B.R. 727, 737 (Bankr. W.D. Mich. 1992) (Stevenson, J.). Closely examined, this refutation is a complete non sequitur. Stevenson states that the debtor has no rights in the dollars actually applied to the mortgage debt, but Judge Rhodes' point is that the debtor can *stop* application of dollars to the mortgage debt when the property is not being maintained. It is the power to *stop* payment that proves the debtor owns

It might as well be admitted that absolute assignments are security interests, and that rent receivables are, therefore, property of the bankrupt estate. If, in spite of the above tests, it is still insisted that the secured party owns the rents free and clear of any debtor equity, then this forfeiture must be struck down as a clear violation of § 541(c)(1)(B), which provides:

> [A]n interest of the debtor in property becomes property of the estate under subsection (a)(1) . . . notwithstanding any provision in an agreement
> . . .
> (B) that is conditioned on the insolvency or financial condition of the debtor . . . or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property.[153]

In effect, the view of the absolute assignment wherein the debtor forfeits her right to rents upon default violates § 541(c)(1)(B). Even if such a view were an accurate view of state law, which it is not, it would be negated in a federal bankruptcy proceeding. Just as equity inserted itself into debtor-creditor relations centuries ago to prevent forfeitures to mortgagees,[154] Bankruptcy Code § 541(c)(1)(B) intervenes to prevent forfeitures of rent receivables.

The notion of an assignment that is not as security, but rather establishes the secured party as the unique owner of the rent receivables until the debt is paid, is designed to deny bankruptcy court for jurisdiction over the cash flow from the debtor's real estate. If this theory is accepted, no turnover action by the debtor could be sustained. A turnover theory presupposes that the debtor has property rights in the thing to be turned over.[155] Obviously, such a theory decreases the ability of a debtor-in-possession to reorganize a single-asset real estate firm. Real estate receivables are the debtor-in-possession's

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an equity interest in rents after all.

153. 11 U.S.C. § 541(c)(1)(B) (1988).

154. *See In re* Willows of Coventry, Ltd. Partnership, 154 B.R. 959, 963-65 (Bankr. N.D. Ind. 1993) (Grant, J.) (describing Indiana law as interceding in this way); Bryn Athyn Investors, Ltd. v. Hotton/Conam Realty Pension Investors (*In re* Bryn Athyn Investors, Ltd.), 69 B.R. 452, 456-57 (Bankr. E.D.N.C. 1987) (Small, J.) (describing similar North Carolina law). According to Robert Kratovil:

> Any provision in the mortgage purporting to terminate the mortgagor's ownership in case of his failure to make his payments when due is against public policy and is absolutely void. "Once a mortgage, always a mortgage." It cannot be converted into an outright deed by the mere default of the mortgagor. And no matter how the mortgagee seeks to disguise an attempted waiver of the equitable right of redemption, the courts will strike it down.

Kratovil, *supra* note 93, at 3.

155. Under § 542(a), the bankruptcy trustee must be able to "use, sell, or lease" the property under § 363. 11 U.S.C. § 542(a) (1988). Under § 543, turnover requires the custodian to deliver "property of the debtor." *Id.* § 543(b)(1).

only source of cash. Without control of this cash, the administration of such a Chapter 11 case becomes difficult and expensive.[156]

V. ADEQUATE PROTECTION

A. The Automatic Stay

When a mortgagee has not dispossessed the debtor prior to the bankruptcy petition, the automatic stay applies to prevent the mortgagee from performing the act that terminates the debtor's right to collect rent.[157] Thus, § 362(a)(3) prohibits "any act to obtain possession of property of the estate."[158] Meanwhile, § 362(b)(3) permits perfecting acts "to the extent that the trustee's rights and powers are subject to such perfection under section 546(b) of this title or to the extent that such act is accomplished within the period provided under section 547(e)(2)(A) of this title."[159] Therefore, if terminating the trustee's power to collect rents is deemed to be an act of perfection under § 546(b), the automatic stay permits termination of the debtor's right to collect. Section 546(b)(1) provides: "The rights and powers of a trustee under sections 544, 545, and 549 of this title are subject to any generally applicable law that—(A) permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection."[160]

Significantly, § 546(b)(2) allows a secured party to replace clumsy repossessions and receiverships with the elegance of simple notice:

> If . . . a law . . . requires seizure of such property or commencement of an action to accomplish such perfection . . . and such property has not been seized or such action has not been commenced before the date of the filing of the petition; such interest in such property shall be perfected, . . . by giving notice within the time fixed by such law for such seizure or such commencement.[161]

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156. On the other hand, debtors may have the last laugh when their lenders are held liable under the Comprehensive Environmental Relief, Compensation, and Liability Act because they are the controlling "owners" of land contaminated with toxic wastes. *See* United States v. Fleet Factors Corp., 901 F.2d 1550 (11th Cir. 1990) (Kravitch, J.), *cert. denied*, 498 U.S. 1046 (1991).

157. *In re* Park at Dash Point, Ltd. Partnership, 121 B.R. 850, 858 (Bankr. W.D. Wash. 1990) (Volinn, J.), (applying Washington law), *aff'd.* 152 B.R. 300 (D. Wash. 1991), *aff'd*, 985 F.2d 1008 (9th Cir. 1993).

158. 11 U.S.C. § 362(a)(3) (1988).

159. 11 U.S.C. § 362(b)(3) (1988).

160. 11 U.S.C.A. § 546(b)(1) (West Supp. 1995).

161. *Id.* § 546(b)(2).

The mandatory tone of § 546(b) suggests that, when the perfecting act is dispossession, the only perfecting act that is allowed is the *ersatz* system of notification.[162] Any actual attempt to dispossess the debtor-in-possession would violate the stay. For example, a motion to a state court for a receiver would constitute a violation of the automatic stay because it is not a perfecting act sanctioned by § 546(b). Oddly enough, § 362(b)(4) also excuses acts permissible under § 547(e)(2)(A). Although § 546(b) replaces debtor dispossessions with a notice procedure in bankruptcy courts, § 547(e)(2)(A) does not, suggesting that obtaining the receiver under state law is authorized by § 362(b)(3).[163]

Courts have managed to divide themselves over whether dispossession of the debtor is a perfecting act or an enforcing act. This distinction becomes a vital question for avoidance under the trustee's strong-arm power.[164] For the moment, let us assume that the security interest on rent receivables is fundamentally valid in bankruptcy. The question arises as to how and when the debtor-in-possession must provide adequate protection on any security interest in the rents.

B. Adequate Protection As Condition Precedent to Collection

While the automatic stay is in effect, and assuming that the security interest has not been avoided, the secured party is entitled to adequate protection of its security interest in exchange for the trustee's use of the collateral during the bankruptcy proceeding.[165] According to § 363(e):

> [A]t any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale,

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162. *In re* Mears, 88 B.R. 419, 421 (Bankr. S.D. Fla. 1988) (Weaver, J.); *but see In re* 1301 Connecticut Ave. Assocs., 117 B.R. 2, 11 (Bankr. D.D.C. 1990), *aff'd*, 126 B.R. 1 (D.D.C. 1991). In *In re 1301 Connecticut Avenue Associates,* Judge Martin Teel ruled that a § 546(b) notice could not perfect a security interest in rents because District of Columbia law conditioned a receivership upon a finding that the mortgaged property is insufficient to fully secure the mortgagee. In addition, the mortgagee had to file an adversary proceeding against the trustee and prove the facts required by local law to obtain the receiver. *In re 1301 Connecticut Avenue Associates*, 117 B.R. at 9-11. In a later case, however, Judge Teel ruled that the parties could contract for other modes of debtor dispossession, if they chose to do so. *In re* 5028 Wisconsin Ave. Assocs., 167 B.R. 699, 704 (Bankr. D.D.C. 1994).

163. This inconsistency is what might be called a drafting glitch. One may expect bankruptcy courts to ignore the plain meaning of the Bankruptcy Code and insist that obtaining a receiver is barred by the automatic stay.

164. The trustee's strong arm power is provided by 11 U.S.C. § 544(a) (1988). The avoidance theory is discussed *infra* text accompanying notes 255-78.

165. 11 U.S.C. § 363(e) (1988).

or lease as is necessary to provide adequate protection of such interest.[166]

Quite apart from the confusing context of rent receivables, courts are badly divided on the question of exactly when the trustee's duty of adequate protection arises.[167] One theory of adequate protection holds that the right to adequate protection arises as soon as the petition is filed.[168] Under this view, adequate protection is the quid pro quo for the automatic stay's prevention of enforcement acts. When this theory of adequate protection prevails, the trustee may collect no rents, unless the proceeds are adequately protected. Such collection depletes the real estate receivables to the prejudice of an undersecured party. Accordingly, adequate protection becomes the automatic precondition to collecting the cash as soon as the bankruptcy petition is filed.[169]

Taken to its logical conclusion, this theory trumps the trustee's strong-arm power. Collection disencumbers the rent proceeds from the security interest. Yet, if adequate protection must be provided before collection occurs, the trustee cannot avoid the security interest by collecting rent. One of the few cases to follow this theory of adequate protection explicitly is *In re Northport Marina Associates*.[170] There, Judge Cecilia Goetz conceded that the trustee's strong-arm power might be temporarily senior to a security interest on a rent receivable, but that the secured party claiming the receivable had a right to adequate protection before the debtor could use the rent receivable by collecting it:

> But the Debtor cannot void Citibank's lien under 11 U.S.C. § 544 in the sense of wiping that lien out. At best, Section 544 in this context establishes priorities. The right of [the debtor] to the rents is superior to Citibank's but in whatever use [the debtor] makes of the rents it is subject to the restrictions the Code imposes on the use of cash collateral. Once rents are deemed a type of cash collateral subject to the restrictions

166. *Id.*

167. *See generally* Carlson, *supra* note 33.

168. *E.g.*, Ford Motor Credit Co. v. Lee (*In re* Lee), 162 B.R. 217, 223 (Bankr. D. Minn. 1993) (MacLaughlin, J.) (finding that a secured party must receive value as it existed on the day of the petition); *In re* Brinson, 153 B.R. 952, 954 (Bankr. M.D. Fla. 1993) (Proctor, J.) (determining that fair market value is determined as of the date of filing of the petition).

169. For examples of this view, see *In re* Wheaton Oaks Office Partners, 27 F.3d 1234, 1241-42 (7th Cir. 1994) (Manion, J.); *In re* Mount Pleasant Ltd. Partnership, 144 B.R. 727, 737 (Bankr. W.D. Mich. 1992) (Stevenson, J.); *In re* Princeton Overlook Joint Venture, 143 B.R. 625 (Bankr. D.N.J. 1992) (Gindin, J.); *In re* White Plains Dev. Corp., 136 B.R. 93 (Bankr. S.D.N.Y. 1992) (Schwartzber, J.); *In re* Rancourt, 123 B.R. 143, 146-49 (Bankr. D.N.H. 1991) (Yacos, J.).

170. 136 B.R. 911 (Bankr. E.D.N.Y. 1992).

imposed on such property, regardless of whether the mortgagee had taken possession of them pre-petition by appointment of a receiver or other legal action, it becomes irrelevant whether Section 546(b) permits a relation-back pre-petition.[171]

It cannot logically be the case, however, that the obligation to provide adequate protection precedes the trustee's power as transferee of debtor property under the strong-arm power.[172] If it did, then a trustee would have the obligation to protect any unperfected security interest before the hypothetical judicial lien could take priority over it. In short, adequate protection would terminate the strong-arm power. Therefore, to the extent a bona fide purchaser of the debtor could collect free and clear of the security interest on rent receivables, then no obligation to provide adequate protection can arise until the secured party terminates this power.

C. Subjunctive Time

Some courts think that adequate protection does not arise upon the filing of a bankruptcy petition. Rather, it arises when the secured party would have repossessed the collateral under state law.[173] This theory was followed by Judge Volinn in the often cited case of *In re Park at Dash Point Limited Partnership*:[174]

> We are of the view that enforcing the secured creditor's interest in the rents by declaring the mortgagee to be entitled to the rents collected after a certain date when the mortgagee would have been able to enforce that interest in state court but for the automatic stay is a proper exercise of bankruptcy jurisdiction.[175]

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171. *Id.* at 920-21. This statement suffers from a slight imprecision. Judge Goetz writes that *once* rents are deemed a type of cash collateral, the right to adequate protection arises. This assumes that general intangibles are cash collateral, when it is better to admit that general intangibles are not "cash" until they are collected. *See infra* text accompanying notes 188-95. If this minor lapse is overlooked, Judge Goetz explains how the right to adequate protection for the security interest *on the rent receivable itself* prevents any collection that would disencumber the proceeds from the security interest on the receivable.

172. *Accord*, Baybank Valley Trust Co. v. Guay (*In re* Guay), 138 B.R. 3, 4 (Bankr. D. Conn. 1992) (Krechevsky, J.).

173. *In re* Glinz, 69 B.R. 916, 919-20 (Bankr. D.N.D. 1987) (Hill, J.); *In re* Asbridge, 66 B.R. 894, 900-01 (Bankr. D.N.D. 1986) (Hill, J.); *In re* Bessey, 65 B.R. 638, 644 (Bankr. S.D. Cal. 1986) (Malugen, J.); *see* Carlson, *supra* note 33, at 130-35.

174. 121 B.R. 850 (Bankr. W.D. Wash. 1990) (Volinn, J.), *aff'd*, 152 B.R. 300 (D. Wash. 1991), *and sub. aff'd, nom.* Steinberg v. Crossland Mortgage Corp. (*In re* Park at Dash Point Ltd. Partnership), 985 F.2d 1008 (9th Cir. 1993).

175. *Id.* at 860. In so ruling, Judge Volinn contradicts an analogy he made to Article 9 treatment of encumbered accounts. Judge Volinn implied that a lien creditor garnishing a rent

This view of adequate protection is closely connected with the valuation exercise that adequate protection implicitly requires.[176] In evaluating collateral, a court is supposed to imagine what the secured party could have obtained from a foreclosure sale if there had been no bankruptcy. Borrowing from this subjunctive exercise, adequate protection arises only when the secured party would have dispossessed the debtor after bankruptcy. Before then, the trustee may use receivables without having to supply adequate protection. Any collections achieved disencumber the cash from the mortgage lien.

D. On Request Only

Many courts infer from § 363(e) that a trustee has no obligation to provide adequate protection unless a secured party requests it.[177] "Colloquially expressed, if you don't ask for it, you won't get it."[178] This interpretation of adequate protection comes from the exact wording of § 363(e), which provides:

> [A]t any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.[179]

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receivable obtained rights analogous to a lien creditor who had garnished an account encumbered by a perfected Article 9 security interest. If this analysis is followed through, then any amount collected by a bankruptcy trustee is the secured party's cash collateral, which cannot be used without adequate protection. This would be so no matter when the collection takes place. But by allowing the trustee to disencumber rents until the subjunctive time of hypothetical dispossession, Volinn is denying that the initial collections are cash collateral.

176. *See* David Gray Carlson, *Secured Creditors and the Eely Character of Bankruptcy Valuations*, 41 AM. U. L. REV. 63, 70-75 (1991).

177. *In re* Continental Airlines, Inc., 154 B.R. 176 (Bankr. D. Del. 1993) (Balick, J.); *In re* Best Products Co., 138 B.R. 155 (Bankr. S.D.N.Y. 1992) (Lifland, J.), *aff'd*, 149 B.R. 346 (Bankr. S.D.N.Y. 1992); *In re* Continental Airlines, Inc., 134 B.R. 536, 544 (Bankr. D. Del. 1991) (Balick, J.); *In re* Kain, 86 B.R. 506, 512 (Bankr. W.D. Mich. 1988) (Gregg, J.); Greives v. Bank of Western Indiana (*In re* Greives), 81 B.R. 912 (Bankr. N.D. Ind. 1987) (Lindquist, J.); *In re* Offerman Farms, Inc., 67 B.R. 279 (Bankr. N.D. Iowa 1986) (Melloy, J.); *In re* Provincetown-Boston Airline, Inc., 66 B.R. 632, 633-34 (Bankr. M.D. Fla. 1986) (Paskay, J.); First State Bank v. Advisory Info. & Management Sys. (*In re* Advisory Info. & Management Sys.), 50 B.R. 627 (Bankr. M.D. Tenn. 1985) (Lundia, J.); *In re* Briggs Transp. Co., 47 B.R. 6, 8 (Bankr. D. Minn. 1984) (Kressel, J.); United States v. Collins (*In re* Northeast Chick Servs.), 43 B.R. 326 (Bankr. D. Mass. 1984) (Glennon, J.); *In re* Hinckley, 40 B.R. 679 (Bankr. D. Utah 1984) (Clark, J.); *In re* Adams, 2 B.R. 313 (Bankr. M.D. Fla. 1980) (Proctor, J.).

178. *In re* Kain, 86 B.R. 506, 512 (Bankr. W.D. Mich. 1988) (Gregg, J.).

179. 11 U.S.C. § 363(e) (1988).

Under § 363(e), a court must award adequate protection when requested to do so. Therefore, the trustee has no inherent duty to provide adequate protection. Adequate protection arises only when the secured party requests it by filing motion to lift the automatic stay[180] or to sequester rents.[181] Until then, the trustee may continue to collect rents free and clear of the mortgage lien.

E. Rent Receivables as Cash Collateral

If the trustee has no duty to supply adequate protection until the secured party asks for it, a major exception exists when the secured party claims "cash collateral." That term is defined in § 363(a) as follows:

> "[C]ash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, *rents*, or profits of property . . . subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.[182]

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180. Section 362(d)(1) mandates lifting the automatic stay when there is a lack of adequate protection. *See* 11 U.S.C. § 362(d)(1) (1988). It is assumed for the moment that dispossessing the debtor to terminate the debtor's right to collect rents is an enforcing act, not a perfecting act. When the security interest on rent receivables is deemed unperfected, it has been held that lifting the automatic stay is a mere prelude to dispossessing the debtor. It is not dispossession itself and, therefore, not sufficient to perfect the security interest.

181. *See* Sears Sav. Bank v. Tucson Indus. Partners (*In re* Tucson Indus. Partners), 129 B.R. 614 (Bankr. 9th Cir. 1991) (Volinn, J.), *vacated as moot*, 990 F.2d 1099 (9th Cir. 1993); *In re* Raleigh/Spring Forest Apartments Assocs., 118 B.R. 42 (Bankr. E.D.N.C. 1990) (Small, J.); *In re* Selden, 62 B.R. 954 (Bankr. D. Neb. 1986) (Mahoney, J.). No provision of the Bankruptcy Code governs sequestering rents *per se*. Justice John Paul Stevens invited bankruptcy judges to sequester rents under their equity powers. *See* Butner v. United States, 440 U.S. 48, 56-57 (1979). Section 363(c)(4) requires the trustee to segregate cash collateral. A motion to sequester could be viewed as an adjunct to that provision.

In *In re* Polo Club Apartments Associates Ltd. Partnership, 150 B.R. 840 (Bankr. N.D. Ga. 1993), dishonest collecting agents made off with prepetition rents. This theft gave rise to a conversion chose in action. *Id.* at 844. Because the debtor had not been dispossessed from the property, this chose in action belonged solely to the debtor. *See id.* at 855. Judge Stacey Cotton ruled that Georgia law required the debtor to be dispossessed before termination of the debtor's power to disencumber rents could occur. *See id.* at 851.

Judge Cotton went on to rule that the secured party had no right to adequate protection solely because the petition was filed. *Id.* at 854. Furthermore, the act of dispossession was not a perfecting act. *See id.* at 853. Therefore, the automatic stay perpetuated the trustee's right to disencumber rents through collection. A motion to sequester rents, however, would terminate the trustee's power to disencumber rents. *See id.* at 854-55.

182. 11 U.S.C. § 363 (a) (1988), *as amended by* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, sec. 214, § 363(a), 108 Stat. 4106, 4126 (1994) (emphasis added). The reference

When a secured party claims cash collateral, a bankruptcy trustee must apply to the court for permission to spend the cash unless all interested entities consent to its use.[183] Because the trustee must take the initiative, the burden shifts to the bankruptcy trustee to show that adequate protection exists.[184] Therefore, in the case of cash collateral, the duty to provide adequate protection arises at the beginning of the bankruptcy proceeding, even when the secured party has failed to play the supplicant.[185] Accordingly, if the rent receivables are deemed cash collateral, then all of the preceding theories of adequate protection must be displaced, and the secured party has an immediate and automatic right to adequate protection as soon as the petition is filed.

Section 363(a)'s definition of cash collateral specifically mentions "rents." If rents means "real estate receivables,"[186] then the secured party always has the right to adequate protection as to rents—from the start of the bankruptcy proceeding. This would be so under any theory of adequate protection. Indeed, many courts have equated rent receivables with cash collateral.[187]

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to rents was added in 1984. Bankruptcy Reform Act of 1978, 98-353, sec. 442(a), § 363(a), Pub. L. No. 98 Stat. 371 (1984) (codified as amended at 11 U.S.C. § 363(a) (1988)).

183. *See* 11 U.S.C. § 363(c)(2) (1988).

184. *Id.* § 363(o)(1).

185. In *In re* Coventry Commons Associates, 134 B.R. 606, 607 (Bankr. E.D. Mich. 1991), *rev'd on other grounds*, 143 B.R. 837 (E.D. Mich. 1992), Judge Stephen Rhodes wrote, "Whether an asset constitutes cash collateral or not is only important to the determination of which party bears the burden of petitioning the court to resolve any disputes regarding the debtor's use of the asset during the bankruptcy case." This assertion is true only if it is agreed that a trustee has an automatic duty to provide adequate protection as soon as the bankruptcy petition is filed. Judge Rhodes noted that the secured party had undertaken the burden and therefore determining whether real estate receivables are cash collateral was unnecessary. *Id.* at 607.

186. The term "rent" can mean different things in different contexts. Herbert Tiffany identified four meanings: (1) rent receivables in general, (2) specific rent receivables, (3) the right to collect rent receivables, and (4) money successfully collected in satisfaction of a rent receivable. 3 HERBERT T. TIFFANY, THE LAW OF REAL PROPERTY § 876 (3d ed. 1939).

187. *E.g.*, Vienna Park Properties v. United Postal Sav. Ass'n (*In re* Vienna Park Properties), 976 F.2d 106, 111 (2d Cir. 1992) (Meskill, J.); Sears Sav. Bank v. Tucson Indus. Partners (In re Tucson Indus. Partners), 129 B.R. 614, 625 (Bankr. 9th Cir. 1991) (Volinn, J.), *vacated as moot*, 990 F.2d 1099 (9th Cir. 1993); *In re* May, 169 B.R. 462, 467 (Bankr. S.D. Ga. 1994) (David, J.); *In re* Miller, 133 B.R. 882, 886 (Bankr. N.D. Ohio 1991) (Krasniewski, J.); *In re* KNM Roswell Ltd. Partnership, 126 B.R. 548, 556 (Bankr. N.D. Ill. 1991) (Coar, J.); *In re* Rancourt, 123 B.R. 143, 148 (Bankr. D.N.H. 1991) (Yacos, J.); *In re* Somero, 122 B.R. 634, 639-41 (Bankr. D. Me. 1991) (Goodman, J.); Wilhite Pure Oil Truck Stop, Inc. v. McCutchen (*In re* McCutchen), 115 B.R. 126, 133 (Bankr. W.D. Tenn. 1990) (Brown, J.); Capital Realty Investor Tax Exempt Fund Ltd. Partnership v. Greenhaven Village Apartments of Burnsville Phase II Ltd. Partnership (*In re* Greenhaven Village Apartments of Burnsville Phase II Ltd. Partnership), 100 B.R. 465, 471 (Bankr. D. Minn. 1989) (Kressel, J.); *In re* Prichard Plaza Assocs. Ltd. Partnership, 84 B.R. 289, 293 (Bankr. D. Mass. 1988) (Queenan, J.).

This equation is imprecise. A real estate receivable represents a tenant's obligation to pay money for the use of real estate. The promise to pay money is not the same as money, just as inventory is not the same as cash proceeds of inventory. Therefore, it should be understood that rents in § 363(a) refers only to collections, not to real estate receivables itself.[188] According to the legislative history:

> [I]f "non-cash" collateral is disposed of and the proceeds come within the definition of "cash collateral" as set forth in this subsection, the proceeds would be cash collateral as long as they remain subject to the original lien on the "non-cash" collateral under section 552(b). To illustrate, rents *received* from real property before or after the commencement of the case would be cash collateral to the extent that they are subject to a lien.[189]

Furthermore, new § 552(b)(2), amended in 1994, contains this language:

> [I]f 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 . . . then such security interest extends to such rents . . . acquired by the estate after the commencement of the case to the extent provided in such security agreement . . . .[190]

The italicized language points to the collections as rents, not to the intangible receivables, which continue to be noncash collateral.

In *Vienna Park Properties v. United Postal Savings Association (In re Vienna Park Properties),*[191] Judge Thomas Meskill affirmed in an ironic way the proposition that receivables are not the same as cash. In the first part of the opinion, he ruled that rent receivables are cash collateral.[192] But, inconsistently, in the second part of the opinion, he ruled that cash and obligations to pay cash are not the same.[193]

In *Vienna Park Properties*, the parties had set up an escrow fund into which the debtor and others paid cash. This escrow fund was to serve as additional collateral. The secured party, however, forgot to file a U.C.C.

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188. *Accord, In re* Park at Dash Point L.P., 121 B.R. 850, 855-56 (Bankr. W.D. Wash. 1990) (Volinn, J.), *aff'd sub nom.* Steinberg v. Crossland Mortgage Corp. (*In re* Park at Dash Point L.P.), 152 B.R. 300 (D. Wash. 1991), *aff'd*, 985 F.2d 1008 (9th Cir. 1993).

189. S. REP. NO. 989, 95th Cong., 2d Sess. 55 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5841 (emphasis added).

190. 11 U.S.C.A. § 552(b)(2) (West Supp. 1995) (emphasis added).

191. 976 F.2d 106 (2d Cir. 1992).

192. *Id.* at 113.

193. *Id.* at 116.

financing statement. Judge Meskill ruled that the security interest in the escrow fund was unperfected and, hence, void in the bankruptcy.[194] The secured party had tried to argue that the escrow fund was money, a security interest in which might be perfected by possession. Meskill ruled that "[a] contractual right to obtain money at some future time is not the same thing as money itself."[195] Therefore, the escrow fund was a general intangible, not cash.

Similarly, the real estate receivable is not cash either. It becomes cash collateral only when collected. Hence, for those inclined to believe that the trustee may use noncash collateral without adequately protecting it (until such time as the secured party asks for it), it also follows that the trustee can collect the receivable and thereby disencumber the receivable from the security interest. In other words, the debtor's right to disencumber rents survives the bankruptcy petition and is transferred to the trustee, until the secured party makes the request that § 363(e) supposedly requires.

F. No Right at All

Judge James Queenan has taken the position that adequate protection is never an impediment to a trustee's expropriation of rent collections. In *In re Mullen*[196] Judge Queenan theorized that if the trustee expropriates rents as they are collected, the secured party is adequately protected because the expropriated rents are replaced by new rents that accrue over time.

> [The secured party] says the value of its interest in the Debtor's property declines each time the Debtor consumes a month's rent in its operations. That is not so. Although [the secured party] loses its security interest in each month's rents as the rents are consumed, [the secured party] retains its security interest in all future rents. The value of that stream of future rents is not declining. The lien on each month's rents replaces the lien on the prior month's rents, so there is a replacement lien of equal value, within the meaning of section 361.[197]

In claiming that the debtor can expropriate proceeds of rent because the expropriated amounts are constantly replaced by new proceeds that become due as time passes, Judge Queenan analogized real estate mortgages to security interests on inventory or accounts receivable under Article 9:

194. *Id.* at 117.
195. *Id.* at 116.
196. 172 B.R. 473 (Bankr. D. Mass. 1994).
197. *Id.* at 476.

> A lender's security interest in receivables or inventory and their proceeds provides an analogy to the security interest in rents. A receivable or inventory lender does not lack adequate protection, even if it is undersecured, so long as the value of the stream of future accounts or inventory and their proceeds is not declining. As a result, orders routinely issue authorizing a debtor to use a lender's cash collateral consisting of the proceeds of receivables or inventory. The lender cannot complain about the debtor's consumption of any particular proceeds. Those proceeds are used to generate new collateral and new proceeds. Assuming the debtor is operating at no less than a break even, the new collateral and proceeds will be of at least equivalent value of those they replace. The same is true of each month's rents received by the Debtor.[198]

It is true, as Judge Queenan suggested, that Article 9 security interests have a renewable quality. When a debtor sells inventory free and clear of the security interest and then spends the cash collateral on new inventory, the secured party has conceivably obtained adequate protection for the inventory because cash collateral was created to replace it. Meanwhile, the secured party has been adequately protected for the cash collateral because new inventory was bought with the cash.

Rent receivables are not different in nature. If a tenant signs a long-term lease, a single rent receivable is created, which the tenant must pay over time. When that lease has expired, the tenant vacates and allows a replacement tenant to take over, replacing one rent receivable with another. As long as the encumbered reversionary interest in the underlying real estate holds its value, the secured creditor is adequately protected with replacement collateral.[199]

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198. *Id.* at 477-78 (footnotes omitted).

199. *See id.* at 478; *see also In re* Citicorp Park Assocs., 180 B.R. 15 (Bankr. D. Me. 1995) (Goodman, J.) (following *Mullen*); *In re* Barkley 3A Investors, Ltd., 175 B.R. 755, 758-60 (Bankr. D. Kan. 1994) (Flanagan, J.) (following *Mullen*): *In re* Ledgemere Land Corp., 116 B.R. 338, 343 (Bankr. D. Mass. 1990) (Queenan, J.) (recognizing that adequate protection focuses on the entire property, not solely the interest in rent receivables); *In re* Prichard Plaza Assocs. Ltd. Partnership, 84 B.R. 289, 301 (Bankr. D. Mass. 1988) (Queenan, J.) (denying adequate protection to secured party claiming rents).

Similar ideas are set forth in *In re* Stone Ridge Associates, Ltd. Partnership, 142 B.R. 967 (Bankr. D. Kan. 1992). Judge John Flannagan defended the state law notion of connecting power over the rents with possession. This allows the mortgagor to pay taxes and maintain the property, which evidences the debtor's being in possession of the reversionary interest in the real estate. Furthermore, in Chapter 11, the debtor should be a debtor-in-possession, suggesting that the debtor should have an unencumbered cash flow from the property. Thus, the debtor should have all power over cash flow under Chapter 11. *Id.* at 970-71.

Technically, *Stone Ridge* is a strong-arm case, not an adequate protection case. Interestingly enough, Flannagan simply declined to effectuate the strong-arm power where no Chapter 11 reorganization was feasible. *See id.* at 972-73. On this aspect of the case, see *infra* text accompanying notes 275-77.

This view may be compared to the position articulated in *In re Landing Associates, Ltd.*,[200] where Judge Leif Clark found that the security interest on rent receivables was "decidedly distinct from those conferred by a deed of trust alone."[201] According to Clark, "What appraisers are valuing (or predicting) is what someone would be willing to pay to *own* the property and enjoy its fruits . . . . The right to specific rents *prior* to ownership of the property . . . is *a priori* not calculated into this value."[202] If the real estate can be analogized to a job—human capital or an executory contract—owning the job is one thing and getting paid is quite another. It is a distortion of the employment market to say that salary and hire is the same as (and therefore superfluous to) the job. Similarly, the security interest on the rent receivables is not the same as the real estate itself.[203]

For his contrary view, Judge Queenan drew further support from the landmark case of *United Savings Ass'n of Texas v. Timbers of Inwood Forest Associates, Ltd.*,[204] which established that undersecured creditors should not obtain postpetition interest. In *Timbers* Justice Antonin Scalia strongly implied that undersecured creditors should not improve their position over time. Instead, everything should be frozen as of the time the bankruptcy petition is filed. As Justice Scalia summarized the issue:

> The crux of the present dispute is that petitioner asserts, and respondent denies, that the phrase "interest in property" also includes the secured party's right (suspended by the stay) to take immediate possession of the defaulted security, and apply it in payment of the debt. If that right is embraced by the term, it is obviously not adequately protected unless the secured party is reimbursed for the use of the proceeds he is deprived of during the term of the stay.[205]

Because the undersecured party should be protected only for the value of the collateral on the day of the bankruptcy petition, the undersecured party was not entitled to postpetition interest as part of its right to adequate protection.[206]

Judge Queenan thought that this holding should also apply to security interests on postpetition rent receivables:

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200. 122 B.R. 288 (Bankr. W.D. Tex. 1990).

201. *Id.* at 296.

202. *Id.* at 297.

203. *Accord,* Travelers Ins. Co. v. River Oaks Ltd. Partnership (*In re* River Oaks Ltd. Partnership), 166 B.R. 94, 99 (E.D. Mich. 1994) (Duggan, J.).

204. 484 U.S. 365 (1988) (Scalia, J.).

205. *Id.* at 370-71.

206. *Id.* at 382. The undersecured party in *Timbers* was itself a mortgagee enjoying an improvement in position as rents accrued. *See infra* note 220.

> What [the secured party] actually wants to do is to now realize upon its security interest in rents. In *United Savings Association of Texas v. Timbers of Inwood Forest Associates, Ltd.*, the Supreme Court held a secured creditor's "interest in property" does not include the right to immediate possession of collateral or its proceeds at foreclosure. By the same token, "interest in property" does not include the right to immediate possession of rents.[207]

Mullen is the second reported opinion in which Judge Queenan had disencumbered rent receivables in the name of *Timbers of Inwood Forest.* In the earlier case of *In re Prichard Plaza Associates Ltd. Partnership,*[208] Queenan held that the debtor-in-possession could expropriate all rents without providing any adequate protection.[209] From *Timbers*, Queenan induced that "adequate protection of a security interest consists of protection against decline in the value of the security interest rather than protection against loss of the opportunity of present realization on the collateral."[210] As applied to real estate cases, Queenan thought that so long as the value of the real property was not declining adequate protection was satisfied. Meanwhile, the trustee could collect the rent receivables as if they were disencumbered for the duration of the bankruptcy proceeding.[211]

Judge Queenan's use of *Timbers* in these two opinions is not immune from criticism. In deciding that undersecured parties did not deserve postpetition interest, Justice Scalia specifically pointed out that under § 552(b) the secured party with an assignment of rents was guaranteed an income flow after

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207. In re Mullen, 172 B.R. 473, 476-77 (Bankr. D. Mass. 1994) (footnote omitted).

208. 84 B.R. 289 (Bankr. D. Mass. 1988).

209. *Id.* at 301-02. Queenan also delved into Massachusetts law to find that the assignment of rents added nothing to the basic mortgage right. *See id.* at 297. He found that the assignment of rents, by its terms, ambiguously attempted to expand the rights of the mortgagee beyond what state law supplied in the absence of the assignment. *Id.* at 299. Hence, prior to this dispossession, the debtor continued to have the right to collect rent. In this circumstance, Queenan observed, the secured party's security interest in rent was "more accurately described as inchoate rather than unperfected." *Id.* at 298. For this reason, Judge Queenan ruled that § 546(b) could not justify a postpetition sequestration of rents for the secured party. Dispossession of the debtor was enforcement, not the perfection to which § 546(b) refers. *Id.* at 299-301.

In *Prichard Plaza* the secured party was collecting some rent at the time of the bankruptcy petition, although other tenants were paying the debtor or paying into escrow. Collection of rents might be evidence that the secured party had effectively dispossessed the debtor from the reversion, but Judge Queenan specifically found that the debtor was still "managing" the property and so had not been dispossessed. *See id.* at 298.

While illuminating, the above discussion was beside the point, because Judge Queenan eventually ruled that the security interest on rent receivables was not entitled to adequate protection. *See id.* at 301.

210. *Id.* at 301.

211. *See id.* at 301-03.

bankruptcy. To give any secured party the same right to an income flow, Scalia thought, was to render § 552(b) superfluous.[212] Yet, when Judge Queenan equated the assignment of rents with an illegitimate claim to postpetition interest, he rendered § 552(b) superfluous in precisely the way that Scalia opposed.

In yet a third unreported opinion, Judge Queenan once again applied his reasoning, but, on appeal, in *Prudential Insurance Co. v. Boston Harbor Marina Co.*,[213] Nathaniel M. Gorton disagreed. While he did not dispute Judge Queenan's reading of Massachusetts law,[214] Gorton thought that the Bankruptcy Code required adequate protection of the rents at issue. All that the security interest lacked, Judge Gorton thought, was its "enforcement."[215] From this premise it followed, without further explication, that the secured party had a "'cash collateral' security interest in post-petition rents."[216] This view comports with the result defended earlier—that the trustee may not use the encumbered rent receivable by collecting it until it is adequately protected. Accordingly, adequate protection arises immediately when the bankruptcy petition is filed.

In *Mullen*, however, Judge Queenan had the last word. He noted that in *Boston Harbor* Judge Gorton had remanded to allow the district court to explore whether the equities exception might apply.[217] The matter settled before Judge Queenan could rule.[218] Judge Queenan observed:

> Significantly, Judge Gorton did not discuss adequate protection principles, apparently because they were not argued. My ruling [in *Boston Marina*] was largely grounded on these principles, but unfortunately it was not accompanied by findings of fact or conclusions of law.
>
> Judge Gorton's decision is therefore not inconsistent with my holding here.[219]

For this reason, Judge Queenan felt at liberty to obliterate the security interest on rent receivables, using *Timbers* as his blunt weapon.[220]

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212. *Timbers*, 484 U.S. at 374.

213. 159 B.R. 616 (D. Mass. 1993).

214. *See In re* Mullen, 172 B.R. 473, 481 (Bankr. D. Mass. 1994) (Queenan, J.); *see also Boston Harbor*, 159 B.R. at 619-21.

215. *Boston Harbor*, 159 B.R. at 621-22.

216. *Id.*

217. *Mullen*, 172 B.R. at 481.

218. *Id.* Judge Queenan used the equities exception as his back-up reason to avoid the security interest in rent receivables. *See infra* text accompanying notes 241-46.

219. *Mullen*, 172 B.R. at 481.

220. Judge Queenan looked to cases that dealt with adequate protection payments actually made to an undersecured party. *See generally* Carlson, *supra* note 24. For example, if a court orders an undersecured creditor to receive payment during the pendency of a bankruptcy proceeding,

the court must decide the meaning or effect of that payment. Payment might reduce the secured claim or it might reduce only the unsecured portion of the total undersecured claim. Of these opinions, Queenan writes, "Most helpful are decisions dealing with disputes concerning the proper application of consensual payment made during the case to the mortgage holder. Most courts hold no adequate protection payments was [sic] necessary when the property's value remains constant." *Mullen*, 172 B.R. at 477.

This is perhaps a misleading description of the case law, and thus Judge Queenan's use of such authority is on shakier ground than the rest of his opinion. If "adequate protection payment" means payment of unencumbered dollars in order to compensate the secured party for depreciation of the collateral, see 11 U.S.C. § 361(1) (1988), the description is perhaps accurate. Some courts think that such narrowly defined adequate protection payments are indeed improper. *See, e.g.*, *In re* Senior Care Properties, Inc., 137 B.R. 527, 529 (Bankr. N.D. Fla. 1992)(Killian, J.); *In re* Laymon, 117 B.R. 856, 865 (Bankr. W.D. Tex. 1990), *aff'd*, No. CIV. A. A-90-CA-1025, 1991 WL 349624 (W.D. Tex. Mar. 22, 1991) *rev'd on other grounds*, 958 F.2d 72 (5th Cir.), *cert. denied sub. nom.* Crozier v. Bradford, 113 S. Ct. 328 (1992).

Surrenders of excess cash collateral—encumbered dollars—must be distinguished from adequate protection payments. Here courts routinely insist that the secured party be paid, even if the value of the collateral remains constant. One example is the famous *Timbers* case. Cash collateral surrenders are more similar to abandonment of over-encumbered collateral than to adequate protection payments in compensation for depreciation expense. To be sure, in both cases, the secured party must apply the dollars received to reduce the total mortgage debt, and also the secured portion of the undersecured claim. When unencumbered dollars are paid, "reducing the secured portion of the undersecured claim" means subtracting the payments from the pre-existing secured claim. When the dollars are encumbered, however, "reducing the secured portion of the undersecured claim" occurs by the very fact of the surrender itself. Any further deduction would constitute double counting. *See* Carlson, *supra* note 29.

Judge Queenan continues:

> For example, in *In re IPC Atlanta Ltd. Partnership*, the debtor had voluntarily made eight mortgage payments during the case. It did so even though the property's value was not declining. The debtor later proposed a plan that sought to apply the payments to the first eight mortgage payments due after confirmation. The mortgagee argued that the payments already made were necessary to adequately protect it against the debtor's use of rents because the rental assignment gave it a separate category of collateral. The payments, said the mortgagee, merely offset the rents used and should not reduce its debt at all. The court disagreed. It viewed the security interest as a whole, treating as one the security interest obtained through the mortgage and the rent assignment. Because the value of that over-all interest was not declining, the court held there was no lack of adequate protection . . . . It therefore allowed the payments to be offset against future plan payments. Not to apply the payments against the debt, the court observed, would allow the creditor to receive more than the amount of its secured claim. Most of the decisions have adopted this reasoning and require postpetition payments to be credited to principal.

Mullen, 172 B.R. at 477 (citing *In re* IPC Atlanta Ltd. Partnership, 142 B.R. 547 (Bankr. N.D. Ga. 1992)) (footnotes omitted).

Judge Queenan somewhat misrepresents the holding in the difficult *IPC* case, because he confuses genuine adequate protection payments with surrenders of cash collateral. In *IPC* Judge Homer Drake effectively disencumbered the security interest on rent receivables, recharacterized the surrendered cash collateral as genuine adequate protection payments, and then insisted that the secured party reduce the secured claim on the reversionary interest of the debtor. In essence, Judge Drake insisted that the secured party repay the debtor the "unencumbered dollars" that had

G. Equity Cushions and § 506(c) Expenses

Although Judge Queenan's remarkable holding swims against the strong riptide of recent authority, there are two important situations where the trustee's duty of adequate protection does not exist or is, at least, entirely consistent with expropriating the rents. First, if the rents constitute a surplus of collateral for the mortgagee, the trustee may use the cash as if the rents were entirely unencumbered.[221] Even though the cash is part of the surplus, it remains cash collateral and, therefore, is subject to § 363(c)(2). Consent or court authority is still required, but adequate protection is not. This rule may be compared to a frequently asserted state law principle that a mortgagee is entitled to a receiver for the collection of rent only when undersecured. If the sale of the underlying real estate is sufficient to cover the mortgage debt, some states will deny the mortgagee the right to a receiver.[222]

Second, adequate protection is not required if the cash is to be used for the benefit of the secured party. Section 506(c) provides, "The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim."[223] Real estate requires maintenance, and when a building is maintained, the expense falls within the scope of § 506(c). Section 506(c) represents the mirror opposite of adequate protection. Whereas adequate protection implies protection against the trustee's administration of the bankrupt estate, § 506(c) implies that the secured party must pay for the trustee's administrative contributions. Section 506(c), therefore, institutes a principle that real estate law vindicates: secured

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wrongfully been paid out. The repayment, however, was exacted in the form of setoffs against the initial payments under the chapter 11 plan due to the secured party. *IPC*, 142 B.R. at 558-59.

Nevertheless, Judge Queenan properly cited *IPC* as support for his controversial holding. In both cases, the security interest on rent receivables was effectively avoided—not under any strong arm or voidable preference theory but under the principles of adequate protection.

Queenan went on to invoke the equities exception to § 552(b), which, he thought, should prevent any secured party from improving his position at the debtor's expense. This aspect of the case is discussed *infra* in the text accompanying notes 241-46.

221. *See In re* James Wilson Assocs., 965 F.2d 160, 171 (7th Cir. 1992) (Posner, J.); *In re* Rancourt, 123 B.R. 143, 151-53 (Bankr. D.N.H. 1991) (Yacos, J.). An oversecured creditor may try to claim that the trustee has the duty to let the cash accrue so that the secured party's right to postpetition interest under § 506(b) might accrue against it. Although some authority exists for the proposition that the trustee has such a duty, the majority view is that the duty does not exist. *See* Carlson, *supra* note 31.

222. *See, e.g., In re* 1301 Connecticut Ave. Assocs., 117 B.R. 2, 11 (Bankr. D.D.C. 1990) (Teel, J.), *aff'd*, 126 B.R. 1 (D.D.C. 1991); Restatement of Property-Security (Mortgages) § 4.3(a) (Tentative Draft No. 3 1994).

223. 11 U.S.C. § 506(c) (1988).

parties have the duty to maintain the value of the collateral on behalf of the debtor during the time the secured parties are in possession.[224]

Neither of the above-described principles is in serious dispute. No right to adequate protection adheres when the cash is part of the equity cushion or where the trustee has a valid § 506(c) claim against the cash. Significantly, both principles find expression in local law apart from federal bankruptcy jurisprudence.

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224. *See Mullen*, 172 B.R. at 477; Note, *supra* note 91, at 1432. According to Judge James Yacos:

> "[R]ents do not spring from the ground"; . . . if the mortgagee seeks to collect the rents the mortgagee must likewise undertake the responsibilities and liabilities of management and operation of the business premises to justify receiving future rent payments. To do otherwise would in effect have the mortgagor act as an indentured servant acting for the mortgagee in operation of the business while allowing the mortgagee to take the fruits of the mortgagor's continuing efforts without any of the liabilities.

In re Rancourt, 123 B.R. at 148 (citation omitted). On the basis of this principle from state law, some courts rule that the security interest on rent receivables exists only to the extent of *net* rents above the amount necessary to maintain the property. *E.g.*, *In re* Willowood East Apartments of Indianapolis II, Ltd., 114 B.R. 138, 143-44 (Bankr. S.D. Ohio 1990) (Sellers, J.). *Contra* Hartigan v. Pine Lake Village Apartment Co., (*In re* Pine Lake Village Apartment Co.), 16 B.R. 750, 756 (Bankr. S.D.N.Y. 1982) (Schwartzber, J.) ("A consent that was given before the expectation of a bankruptcy case cannot be treated as a continuing consent after the filing of a petition for relief under the Bankruptcy Code"); Donahue & Edwards, *supra* note 54, at 677.

For a dissenting view, see Douglas L. Furth, et al., *supra* note 13, at 188. This trio of critics poses the problem of one creditor who owns the rents separately from another creditor, who claims only the reversion following the leases in question. In such a case, they claim, expenditure of rents to maintain the reversion would be unjust. And if this is so when the rent receivables and reversion are separately owned, it must also be true when the two security interests are jointly owned by a single creditor. Thus, the theoretic possibility that a security interest on rents might exist separately from a security interest on the reversion justifies mortgagees milking the property without maintaining it. Presumably theirs is not a bankruptcy logic. Rather, they are claim to describe a general principle of real estate finance.

The exact opposite should be true. If assignments of the pure rent receivable (but not the reversion) are possible, see *supra* n.6, then the lender should understand that this security interest is junior to the obligation of cash flow to maintain the property.

These authors also believe that § 506(c) authorizes only invasion of the specific piece of collateral that is actually benefitted. Thus, if rents have been collected and placed in a bank account, the bank account can only be invaded to justify maintenance of the bank account. The bank account could not be raided to pay for any real estate maintenance. On this view, proceeds could never be invaded to pay for benefits that accrue to the original collateral.

VI. AVOIDANCE POWERS

A. The Equities Exception to § 552(b)

Bankruptcy Code § 552(b) reserves for the mortgagee the right to rents, but it also provides that these rents might be disencumbered from the mortgage "to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise."[225] Various raids on cash collateral have been permitted in the name of equity.[226] Can the equities exception be used to get rid of the security interest on rent receivables?

According to the legislative history, "[i]n the course of such consideration the court may evaluate any expenditures by the estate relating to proceeds and *any related improvement in position of the secured party*."[227] At another place, the history continues:

> If the security agreement extends to . . . rents . . . then the proceeds would continue to be subject to the security interest pursuant to the terms of the security agreement and provisions of applicable law, except to the extent that where the estate acquires the proceeds at the expense of other creditors holding unsecured claims, the expenditure resulted in an improvement in the position of the secured party.[228]

These quotes suggest that improvement in position is to be condemned if it accrues at the expense of the general creditors—a policy that §§ 506(c) and 547(c)(5) contradict.[229]

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225. 11 U.S.C. § 552(b) (1988), *amended by* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, sec. 214, § 552(b), 108 Stat. 4106 (1994).

226. For example, Judge James Yacos has held that, under the "equities" exception, a secured party might have to finance the chapter 11 proceeding. Otherwise, firms whose income streams were encumbered could not reorganize. *In re* Rancourt, 123 B.R. at 148-49. Judge Barbara Sellers would not go this far, but, recognizing that a secured party might maliciously run up the attorneys' fees of a debtor-in-possession by filing "frivolous or ill-founded legal actions," she suggested that § 552(b) would justify paying the debtor's attorneys fees caused by such actions. *In re* Willowood East Apartments, 114 B.R. 138, 144-45 (Bankr. S.D. Ohio 1990).

227. 124 CONG. REC. 32,400 (1978) (statement of Rep. Edwards) (emphasis added).

228. S. REP. NO. 989, 95th Cong., 2d Sess. 91 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5877.

229. Section 506(c) allows the trustee to charge administrative expenses to the collateral to the extent that the expenses benefit the secured party. *See* 11 U.S.C. § 506(c) (1988). Section 547(c)(5) prevents inventory and receivable lenders from improving their position over the preference period, but only if the improvement is prejudicial to the general creditors. *See* 11 U.S.C. § 547 (c)(5) (1988). Therefore, it is not clear that the equities exception condemns *all* improvements in position. Rather, it condemns only the ones that prejudice the general creditors.

Based on the legislative history, many courts find that they may disencumber proceeds only if the secured party improves its position by the trustee's postpetition expenditures.[230] This requirement is significant. In the typical single-asset cases, all cash is cash collateral belonging to the secured party unless an avoidance theory exists to destroy the security interest. Where the debtor-in-possession intends only to spend cash collateral, there have been no postpetition expenditures by the trustee capable of triggering the equities exception.[231]

If trustee expenditure is required to whittle down or perhaps eliminate a secured party's improvement of position after the bankruptcy petition is filed, an allocative rule is needed to determine which part of the improvement of position belongs to the trustee and which part belongs to the secured party. One solution is that the trustee may recover expenses—the result if § 506(c) were applied directly. But is it equitable that the trustee should receive no return on a successful investment? One could affirm such a proposition. The secured party is automatically stayed from recapturing the productive assets. If the secured party were free to seize the collateral and invest in it, perhaps the secured party could capture all the profit of the investment. This subjunctive observation supports the notion that the trustee should never recover more than the cost of the investment from the improvement of position.

Searching for an allocative rule for splitting the gain from investment in the collateral, Judge Arthur Spector in *In re Delbridge*[232] opined that the secured party is entitled to only the percentage of cash proceeds that represent the contribution of collateral to the production of the proceeds.[233] What the secured party contributes, according to Judge Spector, is the depreciation of the existing collateral. What the debtor-in-possession contributes is the

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230. *See, e.g.*, J. Catton Farms, Inc. v. First Nat'l Bank, 779 F.2d 1242, 1246-47 (7th Cir. 1985) (Posner, J.); Wolters Village, Ltd. v. Village Properties, Ltd. (In re Village Properties, Ltd.), 723 F.2d 441, 444 (5th Cir. 1984), *cert. denied*, 466 U.S. 974 (1984) (Garza, J.); Oliver v. MBank Dallas, N.A. (*In re* Oliver), 66 B.R. 426 (Bankr. N.D. Tex. 1986) (Akard, J.); United States v. Van Vactor, Francis & Martin (In re Crouch), 51 B.R. 331, 332 (Bankr. D. Or. 1985) (Sullivan, J.) (noting, "The purpose behind the 'equities of the case' rule . . . is, in a proper case, to enable those who contribute to the production of proceeds during [C]hapter 11 to share jointly with pre-petition creditors secured by proceeds."); *cf.* Airport Inn Assocs., Ltd. v. Travelers Ins. Co. (In re Airport Inn Assocs., Ltd.), 132 B.R. 951, 959 (Bankr. D. Colo. 1990) (Melloy, J.) (finding the prepetition expenditures by the debtor not competent to trigger equities exception).

231. Delbridge v. Production Credit Assoc. 104 B.R. 824, 827 (E.D. Mich. 1989) (Newblatt, J.).

232. 61 B.R. 484 (Bankr. E.D. Mich. 1986), *aff'd*, 104 B.R. 824 (E.D. Mich. 1989) (Newblatt, J.).

233. *Id.* at 491.

maintenance expense of the capital plus the labor needed to bring the proceeds into existence.[234]

In *Delbridge*, the collateral was cows and the proceeds were the milk produced, which was sold to a dairy cooperative. At stake was ownership of the checks issued by the cooperative in exchange for the milk. Spector suggested the following formula:

$$CC = \frac{D}{(D+E+L)} \times P$$

where CC = cash collateral, D = average depreciation per cow, E = average direct expenses maintaining the cow, L = average labor per cow, and P = average cash proceeds per cow.[235] At least one court has thought that this allocation formula has merit for real estate cases,[236] although in affirming the *Delbridge* case on appeal, Judge Stewart Newblatt seemed to disapprove of the formula in dictum.[237]

One problem with this formula is that the secured party is independently entitled to adequate protection for any depreciation (D) that eats into the secured claim itself. If the secured party receives adequate protection for this depreciation, then the secured party is contributing nothing to the cash flow. Based on Spector's formula, the secured party therefore receives zero

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234. *Id.* at 490-92.

235. *Id.* at 490. Judge Spector described this rule as follows:

> The lender is entitled to the same percentage of the proceeds of the post-petition milk as its capital contribution to the production of the milk bears to the total of the capital and direct operating expenses incurred in producing the milk. Because the parties are in a direct mathematical relationship, the rule should be easy to apply. Very simply, the larger is the lender's capital contribution to the venture, the larger its share of the proceeds ought to be. Conversely, if the farmer's input in the venture is great, the "equities of the case" compel that his share of the proceeds likewise be great.

Id. at 491.

236. *In re* Selden, 62 B.R. 954, 958-59 (Bankr. D. Neb. 1986) (Mahoney, J.) (announcing that it would apply some version of the formula).

237. On appeal, Judge Newblatt affirmed the result in *Delbridge*, because the secured party had an equity cushion in the case. *Delbridge*, 104 B.R. at 827-28. Because of the equity cushion, Newblatt allowed the trustee to use cash collateral without any additional adequate protection. *Id.* at 827. However, Newblatt disapproved of Spector's formula because the equities exception is meant to prevent the secured party from benefiting when the trustee invests in the collateral. Because the debtors-in-possession in that case planned only to invest cash collateral in the further improvement of noncash collateral, Judge Newblatt ruled that the equities exception could not be invoked. *Id.* at 826-27. According to this view, Judge Spector's formula cannot be applied unless the debtor invests unencumbered assets into the production of cash proceeds. All of this is dictum, however, since the debtors were permitted to use the cash collateral without any adequate protection anyway.

proceeds.[238] Additionally, in many real estate cases, the collateral never depreciates, even as cash collateral accrues. When a building is well-maintained[239] and the real estate market is stable, the secured party will obtain zero rent, according to Judge Spector's formula.[240]

Judge Spector's formula is highly corrosive to the secured party's rights under § 552(b). While this formula may not please real estate lenders, it is undeniable that where unencumbered dollars have been spent, some allocation formula will be required.

The need for an allocative rule arises from the legislative history, which mentions expense by the trustee as the cause of the secured party's improvement in position. This reference is taken to mean that trustee expense is the *sine qua non* of the equities exception. One aggressive judge reads the legislative history in quite a different light. In *In re Mullen*[241] Judge James Queenan noted that, in the original House version of what would become the Bankruptcy Code, the equities exception required a finding of "prejudice of other creditors."[242] The Senate version required an improvement of position as a result of expense by the trustee—the idea to which the above-quoted legislative history refers.[243] The final version mentioned no such requirements. From this Judge Queenan inferred, "Congress obviously did not wish to limit the exception to those circumstances. The standard for application of the exception—the 'equities of the case'—gives the court the broadest possible charter."[244] Judge Queenan then used this charter to avoid a security interest

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238. Judge Spector worried about the adequate protection of cash collateral, 61 B.R. at 491, but this occurs only *after* his formula determines the secured party's ownership of P. Regarding the underlying collateral that produces P, adequate protection may mean that the secured party is entitled to zero proceeds.

If the above formula is applied in light of an equity cushion, then D can again be said to equal zero, because depreciation does not harm the secured party so long as an equity cushion is present. Such a conclusion means that the secured party's share of postpetition proceeds is always zero. Judge Spector, however, applied his formula to a case involving debtor equity, and found that D had a positive value, thereby winning for the secured party a twenty percent share of the cash proceeds. *Id.*

239. The maintenance is financed out of cash collateral because collateral maintenance is a § 506(c) expense chargeable to the secured party. *See supra* text accompanying notes 223-24.

240. *See, e.g., In re* Ed Woods Livestock, Inc., 172 B.R. 294 (Bankr. D. Neb. 1994) (Minahan, J.) (rejecting an allocation of improvement to the debtor).

241. 172 B.R. 473 (Bankr. D. Mass. 1994).

242. *Id.* at 478 (citing H.R. 8200, 95th Cong., 1st Sess. (1978)).

243. S. 2266, 95th Cong. 2d Sess. § 552(b) (1978).

244. *Mullen*, 172 B.R. at 479. One commentator has complained that the above passage is a mere example, and that he regrets decisions that "have often repeated that example as 'the' purpose of the equity exception." James S. Cole, *The "Carve Out" From Liens and Priorities to Guarantee Payment of Professional Fees in Chapter 11*, 4 DET. C.L. REV. 1499, 1521 (1993). Cole notes that nothing in the text of § 552(b) limits the equities exception to this particular example, and, emboldened by some Supreme Court opinions that denigrate the worth of

on rents because it improved the mortgagee's position over time. During each month, he wrote, the secured party would substantially improve its position.[245] Its unsecured deficit claim would decline while its secured claim remained constant.

> [The] security interest in rents would be thereby changed from one that fills and empties each month to one that increases . . . . The inequity is present even though the estate's expenses for each month are deducted before the monthly turnover or escrow. Reserves for replacement are often necessary. Even with the deduction of any such reserves, however, the paramount inequity would remain. [The secured party] would be enjoying the fruits of the Debtor's labor while [the secured party] in effect conducts a gradual foreclosure [*i.e.*, collects rents through surrenders of cash collateral] at a time when its security value remains constant.[246]

In short, Judge Queenan found that any improvement in position was inequitable. The equities exception, therefore, became the vehicle for total lien avoidance.

A different theory of the equities exception was developed in *Vienna Park Properties v. United Postal Savings Assoc. (In re Vienna Park Properties)*,[247] where Judge Thomas Meskill suggested that it would be "equitable" for a court, under § 552(b), "to strip a creditor of rights to postpetition rents prior to the point at which, under applicable state law, the creditor would likely have been able to enforce those rights."[248] The Bankruptcy Court had not used its equitable powers in this way. Therefore, Meskill ruled that "the rents were properly classified as cash collateral from the date of the commencement of the bankruptcy case."[249]

The security interest in rent receivables was upheld in *Vienna Park Properties* because the bankruptcy court made no findings on the equities exception. In future cases, however, judges in the Second Circuit might use the equities exception to whittle down the security interest in rents. But precisely what was Judge Meskill licensing courts to do in the name of equity? Clearly Meskill intended that some rents should be disencumbered. Upon one reading of this license of free foot, courts should figure out when a secured party hypothetically would have dispossessed a debtor under state law and

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legislative history, he suggests that courts might depart from the example and find new occasions for equitable intervention. *Id.* at 1522 (citing Patterson v. Shumate, 112 S. Ct. 2242 (1992); Toibb v. Radloff, 501 U.S. 157 (1991)).

245. *Mullen*, 172 B.R. at 479.

246. *Id.*

247. 976 F.2d 106 (2d Cir. 1992) (Meskill, J.) (applying Virginia law).

248. *Id.* at 113.

249. *Id.* at 114.

terminate the disencumbrance of rent at that time. This reading accords with an operative theory of adequate protection—that the trustee need not provide adequate protection until the hypothetical time when the secured party would have repossessed the collateral if there were no bankruptcy. Such an appeal to subjunctive reasoning accords with valuation theory—that the collateral must be valued as if there were no bankruptcy. Part of the assumption is a delay in dispossessing the debtor, during which time the debtor could use the rent receivables and disencumber them by collecting.[250]

On another, more extreme reading, Judge Meskill might be suggesting that courts may disencumber all rents because state law enforcement is entirely stayed for the duration of the bankruptcy proceeding. Because disencumbrance continues until the stay is lifted, the secured party is not entitled to adequate protection. Given no right to adequate protection, the secured party cannot obtain a removal of the stay while the property continues to be necessary for an effective reorganization. If the trustee owes no duty of adequate protection and if property is necessary for a reorganization, then the secured party has no grounds on which to insist that the stay be lifted.[251]

Dewsnup v. Timm[252] may affect the scope of the equities exception. It surely eliminates another theory that trustees could have exploited to disencumber rent receivables from security interests. Before *Dewsnup*, debtors could plausibly maintain that once a secured claim is bifurcated, the mortgage for the unsecured deficit is simply avoided. Therefore, all accruing rent beyond the postbifurcation secured claim belonged to the trustee, not the secured party.[253] This theory has been rendered impossible by *Dewsnup*. Instead, bifurcation is final only when the collateral is disposed of or when a reorganization plan is confirmed. In the meantime, all appreciation value and all accruing rents belong to the secured party.

If the Supreme Court thinks that improvement in position of the underlying collateral is equitable, it is a little hard to maintain that the accumulation of proceeds is inequitable. Therefore, *Dewsnup* might constitute a restraint on how the equities exception to § 552(b) is interpreted.

Conversely, Justice Blackmun virtually ordered lawyers not to draw any morals from *Dewsnup* by proclaiming:

250. In *Vienna Park Properties,* Judge Meskill labeled real estate receivables "cash collateral"—even while proclaiming an escrow fund to be noncash collateral, because it was only a general intangible. *See id.* at 117. If this characterization of cash collateral were accepted, the trustee's obligation to provide adequate protection would arise immediately, and Chief Judge Meskill's equities theory could not properly be termed a theory of adequate protection. *See supra* text accompanying notes 191-95.

251. *Cf.* Glessner v. United Nat'l Bank & Trust Co. (*In re* Glessner), 140 B.R. 556, 561 (Bankr. D. Kan. 1992) (Pusateri, J.) (taking this position with regard to Kansas law).

252. 112 S. Ct. 773 (1992).

253. *See* Carlson *supra* note 31, at 127-29.

> The foregoing recital of the contrasting positions of the respective parties and their *amici* demonstrates that § 506 of the Bankruptcy Code and its relationship to other provisions of that Code do embrace some ambiguities. Hypothetical applications that come to mind and those advanced at oral argument illustrate the difficulty of interpreting the statute in a single opinion that would apply to all possible fact situations. *We therefore focus upon the case before us and allow other facts to await their legal resolution on another day.*[254]

This language should suffice to dispel the chance that *Dewsnup* might affect the meaning of the equities exception to § 552(b).

B. The Strong Arm Power

1. Partial Avoidance

A bankruptcy trustee becomes a hypothetical judicial lien creditor and a bona fide purchaser of real estate on the day that the bankruptcy petition is filed.[255] As rent receivables find themselves in the province of real estate, both of these tests are relevant to the priority of a security interest on rent receivables. Nevertheless, the status of a bona fide purchaser and the status of a lien creditor given a recorded real estate mortgage are identical. Each succeeds to the debtor's power to disencumber rents by collecting to the same degree—if at all. Therefore, in the name of convenience, the bankruptcy trustee will be referred to as a hypothetical bona fide purchaser, although it should be understood that whatever is said about this status applies equally to the trustee's status as hypothetical judicial lien creditor.

How does the security interest on rents fare against the trustee's strong-arm power? Courts are divided on the issue.[256] As purchaser, the trustee is certainly on constructive notice of the real estate mortgage itself, if it has been validly recorded before bankruptcy. On the strength of this fact, many courts declare the security interest on rents to be perfected and, hence, totally valid against the trustee's strong-arm power. In other words, recording is said to be perfection, and many courts think that this observation closes the matter.[257] In this vein, it is popular to characterize termination of the debtor's

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254. *Dewsnup*, 112 S. Ct. at 778 (emphasis added) (citation omitted).

255. 11 U.S.C. § 544(a) (1988). *See generally* David Gray Carlson, *The Trustee's Strong Arm Power Under the Bankruptcy Code*, 43 S.C. L. REV. 841 (1992) (providing an overall discussion of the bankruptcy trustee's avoiding powers).

256. A useful state-by-state appendix is provided in Schmitt, *supra* note 50, at 56-58.

257. *See, e.g.*, Commerce Bank v. Mountain View Village, Inc., 5 F.3d 34, 39 (3d Cir. 1993) (Weis, J.); Vienna Park Properties v. United Postal Sav. Ass'n (*In re* Vienna Park Properties), 976 F.2d 106, 111 (2d Cir. 1992) (Meskill, J.); Prudential Ins. Co. v. Boston Harbor Marina

power to disencumber rents as an enforcing act,[258] not a perfecting act. This nomenclature is supposed to prove that the trustee has no strong-arm power against the secured party.[259]

Such nomenclature is merely word-play in the guise of analysis. Just before entering the bankruptcy, the debtor had the right to collect the rents, and when collected, the proceeds belong to the debtor outright. The trustee succeeds to this power as the hypothetical purchaser of the debtor's equity interest in the reversion. If perfection invokes a hypothetical test of status against an intervening bona fide purchaser, then in most states, security interests on rent receivables are not perfected, at least as of the time the bankruptcy petition is filed.[260]

Co., 159 B.R. 616, 619 (D. Mass. 1993) (Gorton, J.); Balcor Pension Investors v. Wiston XXIV Ltd. Partnership (*In re* Wiston XXIV Ltd. Partnership), 147 B.R. 575, 582-83 & n.10 (D. Kan. 1992) (Saffels, J.), *appeal dismissed*, 988 F.2d 1012 (10th Cir. 1993); Federal Land Bank v. Terpstra (*In re* Porter), 90 B.R. 399, 401-04 (N.D. Iowa 1988) (Hansen, J.); *In re* Columbia Office Assocs. Ltd. Partnership, 175 B.R. 199, 202 (Bankr. D. Md. 1994) (Schneider, J.); McCafferty, *supra* note 144, at 471 (equating perfection with public notice).

258. *See In re* Vienna Park Properties, 976 F.2d at 114 (applying Virginia law) (stating that the secured party is not "aided by section 546(b) of the Bankruptcy Code, which provides that certain security interests may be perfected by notice after bankruptcy. As noted above, the security interests in the rents were properly perfected but the steps necessary to enforce those interests were not yet complete"); *In re* Foxcroft Square Co., 178 F.2d 659 (E.D. Pa. 1995) (Gawthrop, J.); *In re* Baltic Assocs., L.P., 170 B.R. 568, 570 (E.D. Pa. 1994) (Hutton, J.) (applying Delaware law); J.H. Streiker & Co., Ltd. v. SeSide Co., Ltd. (*In re* SeSide Co., Ltd.), 152 B.R. 878, 884 (E.D. Pa. 1993) (Bartle, J.); In re Princeton Overlook Joint Venture, 143 B.R. 625, 629-30 (Bankr. D.N.J. 1992) (Gindin, J.); Midlantic Nat'l Bank v. Sourlis, 141 B.R. 826, 833-34 (D.N.J. 1992) (Lifland, J.); *In re* Coventry Commons Assocs., 143 B.R. 837, 838 (E.D. Mich. 1992) (Duggan, J.); Rancourt v. Dionne, 123 B.R. 143, 149 & n.4 (Bankr. D.N.H. 1991) (Yacos, J.); *In re* Raleigh/Spring Forest Apartments Assocs., 118 B.R. 42, 46 (Bankr. E.D.N.C. 1990) (Small, J.); Northwestern Nat'l Life Ins. Co. v. Metro Square (*In re* Metro Square), 106 B.R. 584 (D. Minn. 1989) (Murphy, J.); Capital Realty Investor Tax Exempt Fund Ltd. Partnership v. Greenhaven Village Apartments of Burnsville Phase II Ltd. Partnership (*In re* Greenhaven Village Apartments of Burnsville Phase II Ltd. Partnership), 100 Bankr. 465, 468-69 (Bankr. D. Minn. 1989) (Kressel, J.).

259. *Cf.* 1972 Official Text Showing Changes Made in Former Text of Article 9, secured Transactions, and of Related Transactions, and of Related Sections and Reasons for Changes, General Comment of the Approach of the Review Committee for Article 9 ¶ E-16:

> The term "perfection" is not defined by the [UCC]. In general, it means the point at which a security interest becomes good against third parties when there is also attachment. The additional requirements for perfection beyond the requirements for attachment are set forth in Sections 9-302 to 9-305. It would be unwise to attempt a formal definition of perfection, because of the subtlety of the problems involved in rights against many groups of third persons.

This is advice that many state legislatures and bankruptcy courts have ignored, when they easily equate recordation with defeat of the bankruptcy trustee's strong arm powers.

260. *See* Rogers, *supra* note 53, at 1435 & n.11. For a revealing discussion of the

"Perfection" is surely a *federal* concept. When state law proclaims an assignment of rents perfected as a general proposition, bankruptcy courts are not necessarily bound by this. Instead, they must assess the perfection of the security interest according to their own federal notions.

As earlier explained, § 546(b) preserves state law grace periods by providing in part:

> (b)(1) The rights and powers of a trustee under sections 544, 545, and 549 of this title are subject to any generally applicable law that—
>
> (A) permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection.[261]

Thus, § 546(b) refers to perfection that is "effective against an entity that acquires rights in such property before the date of perfection." This language suggests that perfection must constitute a hypothetical test of the sort that § 547(e)(1) provides in voidable preference law.[262] Section 547(e)(1) defines perfection solely for the purpose of § 547(b) avoidance. But if we liberate that definition from its confines in § 547, we learn that

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enforcement-perfectiondistinction, see McCafferty, *supra* note 144, at 470-71, wherein we learn:

> Perfection is thus a concept involving the relative interests of the lienholder and an intervening third party. It does not deal with the relationship between the debtor and the secured party, or between the secured party and the collateral property. Those latter relationships raise only the question of "enforcement" of the security interest.

Id. On the contrary, because the debtor-in-possession inherits the ability to disencumber rents, dispossession of the debtor will involve "the relative interests of the lienholder and an intervening third party." Thus, the distinction between perfection and enforcement is a false one. Just as a pledgee out of possession who repossesses simultaneously perfects *and* enforces, so a mortgagee out of possession who dispossesses the debtor or some purchaser from the debtor both perfects and enforces the security interest on rents.

This point is overlooked by Professor Patrick Randolph, who made an analogy to repossession of equipment under Article 9. Randolph reasoned that because repossession is not perfection, neither should be dispossession of the debtor in a real estate case. Randolph, *supra* note 49, at 318-19. This analogy is a false one, however. When a secured party perfects under Article 9, no judicial lien creditor or purchaser of equipment can ever obtain better priority than the secured party. This same test, applied to real estate cases, produces a different result—temporary superiority of the purchaser who succeeds to the debtor's power to collect rent receivables free and clear of the security interest.

261. 11 U.S.C. § 546(b)(1) (1988), *as amended by* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, sec. 204, § 546(b)(1), 108 Stat. 4106, 4122 (1994).

262. *See In re* 1301 Conn. Ave. Assocs., 117 B.R. 2, 10 (Bankr. D.D.C. 1990) (Teel, J.), *aff'd*, 126 B.R. 1 (D.D.C. 1991); *In re* Microfab, Inc., 105 B.R. 152, 157 (Bankr. D. Mass. 1989) (Kenner, J.) (stating that "[T]o perfect a lien or other security interest is to satisfy all the conditions necessary to make the lien effective against third parties and, in the case of a statutory, non-consensual lien, against the property owner").

> a transfer of real property other than fixtures . . . is perfected when a bona fide purchaser of such property from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest that is superior to the interest of the transferee.[263]

As applied to mortgages recorded prior to the bankruptcy petition where the mortgagee has not yet dispossessed the debtor, a purchaser takes an interest that is superior to the mortgagee. The purchaser is allowed to collect rents free and clear of the mortgage lien. This superiority, however, is temporary. The mortgagee may terminate the debtor's power by dispossessing the purchaser. There is no good reason why this cannot be called a perfecting act with a relation-back effect.[264] Thus, if under state law the debtor sells the reversion to a purchaser, the purchaser takes over the debtor's right to collect, but this right may be terminated by the mortgagee's act—which we assume *ex hypothesi* to be a perfecting act. If the mortgagee so reacts to the purchase, then any future amounts not yet collected may not be paid to the debtor's successor. Rather, the future amounts must be paid to the mortgagee. This

263. 11 U.S.C. § 547(e)(1)(A) (1988).

264. For cases so holding, see Virginia Beach Federal Sav. & Loan Ass'n v. Wood, 901 F.2d 849, 852 (10th Cir. 1990) (per curiam) (applying Oklahoma law); Waldron v. Northwest Acceptance Corp. (*In re* Johnson), 62 B.R. 24, 28-30 (Bankr. 9th Cir. 1986) (Elliot, J.) (applying Washington law); Wolters Village, Ltd. v. Village Properties, Ltd. (In re Village Properties, Ltd.), 723 F.2d 441, 445 (5th Cir. 1984) (Garza, J.) (applying Texas law), *cert. denied*, 466 U.S. 974 (1984); *In re* Mews Associates., L.P., 144 B.R. 867, 869 (Bankr. W.D. Mo. 1992) (Federman, J.); Home Savings Ass'n v. Woodstock Associates I, Inc. (*In re* Woodstock Associates I, Inc.), 120 B.R. 436, 446-48 (Bankr. N.D. Ill. 1990) (Squires, J.); Chaussee v. Morning Star Ranch Resorts Co. (*In re* Morning Star Ranch Resorts), 64 B.R. 818, 821-23 (Bankr. D. Colo. 1986) (Matheson, J.); *In re* Winzenburg, 61 B.R. 141, 143-45 (Bankr. D. Iowa) (Melloy, J.), *aff'd*, No. 85-01128W, 1986 Wl 21352 (N.D. Iowa, Dec. 17, 1986); United States v. Farrell (In re Fluge), 57 B.R. 451, 456-57 (Bankr. D.N.D. 1985) (Hill, J.) (applying North Dakota law); Consolidated Capital Income Trust v. Colter, Inc., 47 B.R. 1008, 1011 (D. Colo. 1985) (Matsch, J.) (applying Colorado law).

In SLC Ltd. V v. Bradford Group West, Inc. (*In re* SLC Ltd. V), 152 B.R. 755, 761 (Bankr. D. Utah 1993), Judge Judith Boulden ruled that dispossession in a straight mortgage case is a perfecting act, but dispossession in light of an express assignment of rent is not. This ruling is peculiar because it means that a purchaser or lien creditor can collect free and clear, pending the dispossession. A slightly more defensible view along these lines is that the assignment of rents allows for contractual variation on the termination of the debtor's power to collect. Thus, perhaps the parties could agree that the debtor's power to collect terminates when the debtor defaults. On this basis it is possible to conclude that dispossession is not perfection when the parties have agreed to an assignment of rents.

ability to take back the rent receivables establishes a "relation back"[265] within the meaning of § 546(b).[266]

To be sure, the second clause of § 546(b) obviates the need to actually dispossess the debtor-in-possession, as a hypothetical purchaser. According to that clause:

> (2) If -
>
> (A) a law . . . requires seizure of such property or commencement of an action to accomplish such perfection . . .; and
>
> (B) such property has not been seized or such action has not been commenced before the date of the filing of the petition;
>
> such interest in such property shall be perfected . . . by giving notice within the time fixed by such law for such seizure or such commencement.[267]

Therefore, if the debtor files for bankruptcy when the debtor still has the power to disencumber a rent receivable by collecting it, the security interest in rent receivables is unperfected, and the amounts actually collected by the

265. *See In re 1301 Conn. Ave. Assocs.*, 117 B.R. at 10-11 (applying District of Columbia law). Thus, in *In re* Wheaton Oaks Office Partners, Ltd. Partnership, 27 F.3d 1234, 1245 (7th Cir. 1994) (quoting Stevens v. Blue, 57 N.E.2d 451 (Ill. 1944)), Judge Daniel Manion wrote:

> [U]nder Illinois law, even if a junior lienholder "wins the race" to possession, his right to collect the rents is still subject to the previously recorded, yet unenforced rent assignment of a previous mortgagee. If it were not so, that is, [if] the mortgagee's superior right to the rents could be extinguished by virtue of an intervening judgment creditor, then how could the Illinois Supreme Court . . . declare the intervening judgment creditor to be a "subordinated" lienholder?

266. In United Savings Ass'n v. Timbers of Inwood Forest Associates, Ltd., 484 U.S. 365 (1988), Justice Antonin Scalia cited with apparent approval cases in which the strong arm power avoided in whole or in part security interests on rent receivables. *Id.* at 374 (noting, "Section 552(b) sets forth an exception, allowing postpetition 'proceeds, product, offspring, rents, or profits' of the collateral to be covered only if the security agreement expressly provides for an interest in such property, and the interest has been perfected under 'applicable nonbankruptcy law'") (citing Casbeer v. State Fed. Sav. & Loan Ass'n (*In re* Casbeer), 793 F.2d 1436 (5th Cir. 1986) (granting partial avoidance under Texas law); *Johnson*, 62 B.R. at 28-30 (granting total avoidance under Washington law)).

267. 11 U.S.C. § 546(b) (1988), *as amended by* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, sec. 204, § 546(b), 108 Stat. 4106, 4122 (1994). Because § 546(b) substitutes notice for dispossession of the debtor, courts have reasoned that a motion to lift the automatic stay is insufficient to perfect the security interest on rent receivables. Therefore, the trustee's right to collect rent survives lifting the automatic stay until the secured party actually dispossesses the trustee under state law or pursuant to § 546(b). *See, e.g.*, Village Properties, 723 F.2d at 446-47; Drummond v. Farm Credit Bank (*In re* Kurth Ranch), 110 B.R. 501, 507 (Bankr. D. Mont. 1990) (Peterson, J.).

In contrast, Judge David Houston, in Delta Plaza Partners v. Minnesota Mutual Life Insurance Co. (*In re* Delta Plaza Partners), 133 B.R. 355, 359 (Bankr. N.D. Miss. 1991), ruled that a counterclaim in an adversary proceeding could constitute notice under § 546(b).

debtor-in-possession are not cash collateral. This situation can be reversed when the mortgagee complies with the notice provision in § 546(b).

Some courts apply an apparently federal test of their own devise that analyzes whether it is possible to avoid the security interest. If not, then the security interest is perfected.[268] In short, temporary unperfection is simply to be ignored when the mortgage is recorded.[269] This view also evades the crucial issue. An intervening purchaser can avoid the security interest by collecting the rents prior to dispossession. This temporary avoidance is enough to justify calling the security interest unperfected pending the perfecting act described by § 546(b).

The purpose of § 546(b) is to deal with unperfection, coupled with a state grace period that allows the creditor to retake priority from an intervening lien creditor or purchaser of the debtor's real property. For example, § 546(b) is usually associated with mechanics' liens, for which a supplier of goods or services must file a notice before some deadline to prevail against prior encumbrances.[270] It also is associated with U.C.C. section 9-301(2), in which Article 9 secured parties are unperfected against judicial lien creditors, but may regain priority if they file within ten[271] days of the debtor receiving possession of the collateral. Both of these concepts involve temporary juniority, which might be rectified by some postpetition perfecting act. Security interests on real estate receivables should be similarly analyzed, given

268. *See, e.g.*, J.H. Streiker & Co., Inc. v. SeSide Co., Ltd. (*In re* SeSide Co., Ltd.), 152 B.R. 878, 884 (E.D. Pa. 1993) (Bartle, J.); *In re* KNM Roswell Ltd. Partnership, 126 B.R. 548, 552-53 (Bankr. N.D. Ill. 1991) (Coal, J.); *In re* Park at Dash Point L.P., 121 B.R. 850, 853 (Bankr. W.D. Wash. 1990), *aff'd*, 152 B.R. 300 (D. Wash. 1991), *aff'd*, 985 F.2d 1008 (9th Cir. 1993); *In re* Foxhill Place Assocs., 119 B.R. 708, 711-12 (Bankr. W.D. Mo. 1990) (Fox, J.).

The *Foxhill* case is peculiar because Judge Karen See labored hard to demonstrate that dispossession of the debtor is an enforcing, not a perfecting, act. 119 B.R. at 711-12. She then required the secured party to file a motion to lift the automatic stay, sequester rents, or prohibit the use of cash collateral as substitutes for dispossession, which the automatic stay forbids. Prior to the motion, the trustee had unfettered power to disencumber rents. *See Foxhill*, 119 B.R. at 713-14. In effect, Judge See ruled that the security interest on rent receivables was unperfected after all.

269. One commentator in support of this view writes, "The fact that the junior recorded creditor . . . could temporarily take control of the property to which the rent assignment relates is immaterial. At no time is the junior recorded creditor's interest superior to that of the first creditor. It is merely enforced while the first creditor's interest is not." Schmitt, *supra* note 50, at 38. This is no argument but merely a pronouncement.

270. *E.g.*, Yobe Elec., Inc. v. Graybar Elec. Co. (*In re* Yobe Elec., Inc.), 728 F.2d 207 (3d Cir. 1984) (per curiam).

271. Many nonuniform amendments to U.C.C. § 9-301(2) have extended this period to twenty days. In recognition of this fact, Congress has recently extended the grace period in § 547(c)(3)(B) to twenty days as well, but the grace period in § 547(e)(2)(A) remains at ten days. *See* 11 U.S.C.A. § 547(c)(3)(B) (West Supp. 1995).

a judicial lien creditor's right to succeed to the debtor's power to collect rents free and clear of the mortgage lien.

2. *Total Avoidance*

Many courts have professed themselves unable to find any relation-back theory under state law,[272] often because no statute expressly uses that retrospective trope.[273] When such an assertion was coupled with the view

272. *See, e.g.*, Sears Sav. Bank v. Tucson Indus. Partners (*In re* Tucson Indus. Partners), 129 B.R. 614, 622-23 (Bankr. 9th Cir. 1991) (Volinn, J.), *vacated as moot*, 990 F.2d 1099 (9th Cir. 1993) (applying Arizona law); In re Princeton Overlook Joint Venture, 143 B.R. 625, 632 (Bankr. D.N.J. 1992) (Gindia, J.); *In re* Harbour Town Assocs., Ltd., 99 B.R. 823 (Bankr. M.D. Tenn. 1989) (Paine, J.); Exchange Nat'l Bank v. Gotta (*In re* Gotta), 47 B.R. 198, 202 (Bankr. W.D. Wis. 1985) (Martin, J.).

In Casbeer v. State Federal Savings & Loan Ass'n (In re Casbeer), 793 F.2d 1436 (5th Cir. 1986), Judge Thomas Gibbs Gee described Texas law as requiring not only the assignment of rents, but also the express statement that the assignment of rents is to be senior to any subsequent lien. The failure to reserve seniority over subsequent liens is said to be the *sine qua non* of the relation back effect that occurs when the secured party takes back control over collection of rents. For this proposition, Judge Gee cited a Texas case that utterly fails to support the proposition. *See Casbeer*, 793 F.2d at 1443 (citing Vahlsing Christina Corp. v. First Nat'l Bank, 491 S.W.2d 954 (Tex. Civ. App. 1973) (holding that a subordination agreement covering personal property and equipment did not extend to real property liens)).

Surely the mere taking of an assignment of rent implies that the assignment is to be senior over subsequent assignments. Why should priority depend upon its express reservation in the mortgage agreement?

The above analysis conceptualizes the security interest on real estate receivables as pre-existing the secured party's seizure of the power to collect. In Commerce Bank v. Mountain View Village, Inc., 5 F.3d 34 (3d Cir. 1993), Judge Joseph Weis confused matters by simultaneously asserting that the security interest on receivables pre-exists seizure of control over collection and that the seizure of control itself is also a transfer. First, he wrote that "by entering the property and collecting the rents, the banks were 'enforcing' their rights, not 'perfecting' their liens. The banks' liens arose when the mortgages were recorded. Liens arising at a later date would be junior to that of the banks." *Mountain View*, 5 F.3d at 39. Conversely, in the next sentence he continued:

> We recognize that mortgagees have *no right* to the rents until a default has occurred and, before they give notice, a junior lienor can attach rents that otherwise would come into the possession of the mortgagor. Once having given notice and enforcing its rights, however, a mortgagee would prevail over the junior lienor.

Id. (emphasis added) (citing Colbassani v. Society of Christopher Columbus, 48 A.2d 106 (1946); Miners Sav. Bank v. Thomas, 12 A.2d 810 (1940)). How can the secured party both have a pre-existing right and not have a pre-existing right? The paradox is solved if it is recognized that the right to rent pre-exists seizure of control of collection. The latter is not a transfer, but merely the disappearance of a condition subsequent on that right.

273. *Cf.* Klein v. Civale & Trovato, Inc. (*In re* Lionel Corp.), 29 F.3d 88, 93-94 (2d Cir. 1994) (Walker, J.) (stating that a statute need not expressly set forth relation back principle so long as the practical effect of relation back exists). In comparison, one oft-cited commentator complains that no grace period exists because "[t]here is no recording statute . . . that says a

that dispossession of the debtor was a perfecting act, the result was total avoidance of the security interest on rent receivables.[274]

The avoidance of security interests on rent receivables constitutes the most radical prodebtor position available, yet its consequences should not be overestimated. The mortgage on the reversion remains valid. In a Chapter 11 proceeding, the secured party is entitled to receive the value of the collateral in a cram down. The valuation, in essence, awards to the secured party the present value of all rents as of the effective date of the Chapter 11 plan. Control of the cash flow during the pendency of the Chapter 11 proceeding is at stake. Avoidance of the security interest under the strong-arm power, however mistaken, does no more than to reduce mortgagees to the status of undersecured creditors who do not control cash flow. That is, mortgagees are entitled to the value of their collateral as of some specific point in time, but they are prohibited from improving their position over time.

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security interest in rents is good against an intervening transferee if notice of the security interest in rents is good against an intervening transferee if notice of the security interest is recorded within some number of minutes, or days, or weeks, after the interest was created." McCafferty, *supra* note 144, at 464. True, recording acts do not mention any such thing, but the relation-back effect is with regard to the ability of a mortgagee to take back a rent receivable that a bona fide purchaser has succeeded to. McCafferty also complains that

> the legislative history of Section 546(b) makes it clear that there must be some date "before the commencement of the case" to which the post-petition perfection must relate back. What date is that, in the case of an assignment of rents? There is none, because there is no known non-bankruptcy law . . . which creates a "relation back" mechanism . . .

Id. (*citing* H. REP. NO. 595, 95th Cong., 1st Sess. 86-87 (1977)). It is easy to locate the date back to which the recapture of the rent receivable relates. It relates back to the time the mortgage lien first attached to the rent receivable taken back from the purchaser.

274. *See, e.g.*, Saline State Bank v. Mahloch, 834 F.2d 690, 694-95 (8th Cir. 1987) (Lay, J.) (discussing the issue in dictum); *In re* Stanley Station Assocs. L.P., 139 B.R. 990, 1009 (Bankr. D. Kan. 1992) (Flannagan, J.); *In re* Harvey Road Assocs. VIII, 140 B.R. 302, 305 (Bankr. D. Mass. 1992) (Hillman, J.) (finding that under New Hampshire law, no perfection existed because no attachment had occurred); Glessner v. United Nat'l Bank & Trust Co. (*In re* Glessner), 140 B.R. 556, 561 (Bankr. D. Kan. 1992) (Pusateri, J.); *In re* Wynnewood House Assocs., 121 B.R. 716, 724-26 (Bankr. E.D. Pa. 1990); *In re* Westport-Sandpiper Assocs. Ltd. Partnership, 116 B.R. 355 (Bankr. D. Conn. 1990) (Shiff, J.) (applying Florida law, but refusing to apply the Florida corrective statute retrospectively); *In re* Forest Ridge, II, Ltd. Partnership, 116 B.R. 937, 946-48 (Bankr. W.D.N.C. 1990) (Wooton, J.); Drummond v. Farm Credit Bank (*In re* Kurth Ranch), 110 B.R. 501, 506 (Bankr. D. Mont. 1990) (Peterson, J.); *In re* Harbour Town Assocs., Ltd., 99 B.R. 823 (Bankr. M.D. Tenn. 1989) (Paine, J.); *In re* Camelot Assocs. Ltd. Partnership, 102 B.R. 161 (Bankr. D. Minn. 1989) (Kishel, J.) (applying Florida law, but refusing to apply Florida corrective statute retrospectively); Kearney Hotel Partners v. Richardson (*In re* Kearney Hotel Partners), 92 B.R. 95, 103-08 (Bankr. S.D.N.Y. 1988) (Buschman, J.); *In re* TM Carlton House Partners, Ltd., 91 B.R. 349, 357 (Bankr. E.D. Pa. 1988) (Scholl, J.); *In re* Association Ctr. Ltd. Partnership, 87 B.R. 142, 145-46 (Bankr. W.D. Wash. 1988) (Steinel, J.).

On this basis, Judge John Flannagan in *In re Stone Ridge Associates, Ltd. Partnership*[275] held that the strong-arm power is capable of defeating a security interest on rent receivables altogether, and he defended the premise that in Chapter 11 the debtor deserved to control the cash flow.[276] But because the collateral had already been abandoned to the secured party, no Chapter 11 plan was feasible. Judge Flannagan simply refused to avoid the security interest based on some sort of equitable abstention theory.[277]

Some courts unable to find the relation-back effect make the error of concluding that debtor dispossession serves merely to establish the secured party's right to rents going forward. Dispossession has no effect on rents already collected or, perhaps, on rents already accrued.[278] Therefore, no relation-back effect exists. This view, however, makes the common error of equating a conditional obligation of a tenant to pay rent in the future with no obligation to pay. For example, suppose that a tenant signs a twenty-year lease and that a mortgage lien attaches to this receivable. The tenant only has to pay rent as the requisite time passes. The lease is nevertheless a receivable once the lease is signed. Suppose that the lease is signed on January 1, 1990. A mortgage lien attaches to the rent receivable on the same day. Years later, on January 2, 1995, the debtor files for Chapter 11 protection. On January 10, the tenant pays rent for the month of December, 1994. This rent belongs to the bankruptcy trustee free and clear under the view that holds dispossession of the debtor is a perfecting act. Suppose that on January 15 the secured party files the notice required by § 546(b).

Ex hypothesi, this notice perfects the security interest by displacing the trustee as bona fide purchaser of the reversionary interest. All future rents are the secured party's cash collateral, and a relation-back effect fully exists. The security interest on the rent receivable was created in 1990. The tenant's obligation to pay rent in February 1995 is simply the accrual of the tenant's 1990 obligation to pay. By filing the notice required in § 546(b), the secured party is perfecting a security interest created in 1990. This perfection is good against intervening purchasers, and thus, the relation-back effect required by § 546(b) is fully present.

For this reason, total avoidance is based on the faulty premise that no relation-back effect exists with regard to the mortgage lien on rent receivables.

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275. 142 B.R. 967 (Bankr. D. Kan. 1992).

276. *See id.* at 971-72.

277. On the theory that a bankruptcy court may refuse to avoid transfers for equitable reasons, see Carlson, *supra* note 255, at 912-45.

278. J.H. Streiker & Co. v. SeSide Co., Ltd. (*In re* SeSide Co., Ltd.), 152 B.R. 878, 884 (E.D. Pa. 1993) (Bartle, J.); *see also In re* D'Anna, 177 B.R. 819 (Bankr. E.D. Pa. 1995) (Raslavich, J.) (under Pennsylvania law, amounts collected by debtor-in-possession free and clear of mortgage lien and so could be used to pay debtor's lawyers).

3. The 1994 Legislation

In 1994, Congress amended § 552(b) to make it clear that hotel receipts would be considered proceeds of prepetition collateral, not postpetition accounts that are disencumbered under § 552(a).[279] In the course of achieving this end, Congress added some words that may affect the trustee's avoidance theory. Section 552(b)(2) now upholds security interests in rents "[e]xcept as provided in section . . . 544[] . . . *and notwithstanding section 546(b) of this title*."[280] The reference to § 546(b) is certainly mysterious. One possible meaning is that courts should apply § 544(a) to security interests on rent receivables notwithstanding § 546(b). So read, the secured party has lost the chance to establish a valid security interest on rent receivables going forward.

This new language may mean that § 546(b)'s relation-back requirement is to be ignored. On this wobbly reading, the strong-arm power in § 544 is still efficacious, but § 546(b)'s insistence on relation back is no longer operable.

Perhaps these words mean that secured parties have a valid security interest if they have recorded the mortgage—this takes care of the reference to § 544—but once this is done, secured parties are to have valid security interests on rent receivables "notwithstanding" that they have not complied with the requirements of § 546(b).

What these added words mean is anyone's guess. It can be noted that these words are from the House bill, which substituted for an earlier Senate version in which security interests on rent receivables were declared to be "automatically perfected," whatever that might mean.[281] It is completely

279. *See* 11 U.S.C.A. § 552(b) (West Supp. 1995).

280. *Id.* § 552(b)(2) (emphasis added).

281. S. 540 § 206. This proposed revision stated:

> (2)(A) except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548, if—
>
> (I) the debtor and an entity entered into a security agreement *that was duly recorded* in the public records before the commencement of the case: and
>
> (II) the security interest created by the security agreement extends to—
>
> (I) property of the debtor acquired before the commencement of the case; and
>
> (II)(AA) to amounts paid as rents of such property . . .
>
> the security interest extends to such amounts paid to the estate as rents or as fees, charges, accounts, or other payments after the commencement of the case to the extent provided in the security agreement, *whether or not the security interest in such rents* or such fees, charges, accounts, or other payments is perfected under applicable nonbankruptcy law, except to the extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.
>
> (B) If a security interest extends under subparagraph (A) to rents acquired by the estate after the commencement of the case, the security interest

unclear whether the House version is opposed to or consistent with the displaced Senate version.

Meanwhile, we have seen that the House sponsor of the amendment, Congressman Jack Brooks, has read into the *Congressional Record* a statement to the effect that mortgagees who have recorded mortgages on the underlying real estate have valid security interests in the rents, whether or not they have perfected their security interests under state law.[282] It is all but impossible to obtain this meaning from the actual amendment. Nevertheless, it can be expected that the courts will skip the statutory language and adopt this scrap of legislative history as the governing law.[283]

C. Voidable Preference Theory

Suppose a secured party seizes control of the rents within the preference period or has taken no such action by the time of the petition. Even if the secured party can beat the trustee's strong-arm power with regard to postpetition rents, it remains a possibility that a court will avoid security interests in rent receivables as voidable preferences. This possibility has often been overlooked.[284] In fact, voidable preference concerns arise over nearly every case involving security interests on rent receivables; yet, the matter is rarely discussed.[285]

Having argued that a security interest on rent receivables can have, at best, only a temporary juniority to the trustee's strong-arm power, it would be odd to maintain that the security interest is void as a preference. Accordingly, this position can be resisted on three grounds. First, in the typical single-asset real estate case, the debtor is not insolvent as that concept is defined in the Bankruptcy Code. Second, so long as no receiver had been appointed prior to the bankruptcy petition, the trustee can never establish the hypothetical liquidation test of § 547(b)(5) because if the secured party has received nothing before bankruptcy, the secured party's bankruptcy entitlements will equal the sum of the secured party's prebankruptcy transfers plus bankruptcy entitle-

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> in such rents shall be deemed to be perfected for the purpose of section 544(a).

(Emphasis added). For a critical description of other failed Senate bills, see Donahue & Edwards, *supra* note 54, at 651-54.

282. *See supra* section IV.A.

283. *E.g., In re* Newberry Square, Inc., 175 B.R. 910, 915 (Bankr. E.D. Mich. 1994) (Shapero, J.) (dictum).

284. In Commerce Bank v. Mountain View Village, Inc., 5 F.3d 34, 38 (3d Cir. 1993), Judge Joseph Weis pointed out that the dispossession of the debtor had occurred before the voidable preference period, but apart from this reference and the few cases to be discussed herein, the thought of voidable preferences is never invoked.

285. *See, e.g.*, Averch, *supra* note 6, at 523 & n.34 (conceding a connection between strong arm and voidable preference theory, but denying the validity of the strong arm theory).

ments.[286] Given this equality, the security interest in rents is not preferential—at least insofar as the secured party collects no rents before bankruptcy.

Third, even if the trustee can make out a technical case of voidable preference under § 547, avoidance per se cannot profit the trustee. As will be shown, all that avoidance accomplishes is the setting aside of a transfer that state law otherwise honors. After that, the trustee must expropriate the property for which the transfer was set aside. Expropriation is achieved by the strong-arm power, which means that voidable preference theories cannot extend the trustee's rights past the rights that already exist under the strong-arm power because that power would have existed if no transfer had occurred before bankruptcy.

1. The Banks and Shoals of Timing

Voidable preference law is a threat to the security interest on rent receivables because § 547(e)(2) defers the time of the transfer until the transfer is sufficiently perfected against a bona fide purchaser for value—at least for transfers of real property.

Timing the transfer is vital for determining whether it is a voidable preference. Timing is important for at least three different elements of § 547(b). Knowing when the transfer of debtor property occurred is necessary to determine (a) whether the transfer was on account of an antecedent debt,[287] (b) whether the debtor was insolvent at the time of the transfer,[288] and (c) whether the transfer was within ninety days of bankruptcy[289] —or within one year if the secured party is an "insider" of the debtor.[290]

The timing rules for voidable preference law require a definition of the term "perfection," a task which, as already shown, has divided courts in applying the strong-arm power to the security interest on rent receivables. In that context, procreditor courts have equated recordation with perfection, ignoring the fact that purchasers of the debtor's equity can actually disencumber rents by collecting them. Prodebtor courts have tested the rights of bona fide purchasers to see if the security interest is perfected. The hypothetical bona fide purchaser test also is relevant for voidable preference law because it is expressly set forth in § 547(e)(1)(A), which provides "A transfer of real property other than fixtures . . . is perfected when a bona fide purchaser of such property from the debtor against whom applicable law permits such

286. Regarding this test, see Carlson, *supra* note 25.
287. *See* 11 U.S.C. § 547(b)(2) (1988).
288. *See id.* § 547(b)(3).
289. *See id.* § 547(b)(4)(A).
290. *See id.* § 547(b)(4)(B).

transfer to be perfected cannot acquire an interest that is superior to the interest of the transferee."[291]

Notice that this definition does not account for unperfection pending some future act to establish seniority over an intervening transferee—precisely the dilemma that security interests on rent receivables pose. Nevertheless, this is the definition given to us in order to apply the timing rules supplied by § 547(e)(2). These timing rules are as follows:

> For the purposes of this section, except as provided in paragraph (3) of this subsection, a transfer is made—
>
> (A) at the time such transfer takes effect between the transferor and the transferee, if such transfer is perfected at, or within 10 days after, such time, except as provided in subsection (c)(3)(B);
>
> (B) at the time such transfer is perfected, if such transfer is perfected after such 10 days; or
>
> (C) immediately before the date of the filing of the petition, if such transfer is not perfected at the later of—
>
> (i) the commencement of the case; or
>
> (ii) 10 days after such transfer takes effect between the transferor and the transferee.

11 U.S.C. § 547(e)(2) (1988), *as amended by* Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, sec. 203, 108 Stat. 4106, 4122 (1994)).

The first rule, found in § 547(e)(2)(A), is the mortgagee's best chance to escape liability. This rule looks to the creation of the security interest on rent receivables—what Article 9 would call attachment[292]—to establish the time of the transfer. If § 547(e)(2)(A) applies, the time of the transfer likely is to be beyond the ninety-day preference period.[293] In contrast, if either of the other rules applies, the transfer may be placed within the preference period—a favorable development for the bankruptcy trustee.

For the secured party to invoke the timing rule of § 547(e)(2)(A), the secured party must show perfection within ten days of attachment, to borrow again the Article 9 phrase.[294] In the case of a security interest on rents, the

291. *Id.* § 547(e)(1)(A).

292. U.C.C. § 9-203(1) (3 U.L.A. 363) (1990).

293. Where the security agreement is signed within the preference period, § 547(e)(2)(A) tends to make the extension of credit contemporaneous with the creation of the security interest on the rent receivable. As contemporaneous exchanges of value are not preferential, *See* 11 U.S.C. § 547(b)(2) (1988), the secured party also would escape liability for this reason.

294. The U.C.C. Article 9 concept of the attachment of a security interest requires that a signed security agreement exist, the creditor give value, and the debtor have rights in the collateral. U.C.C. § 9-203(1) (3 U.L.A. 363) (1990). Attachment equates with what § 547(e)(2)(A) calls "the time such transfer takes effect between the transferor and the transferee . . . ."

secured party has a lien on rents as soon as the receivable arises[295] or the underlying mortgage is recorded, whichever is later in time. The receivable arises when the trustee signs the lease. Therefore, if attachment is the standard, the security interest on rent receivables will be deemed a transfer early in time, as compared to the bankruptcy petition. This security interest is nonetheless susceptible of later *pro tanto* destruction—whenever a tenant lawfully pays the debtor prior to the secured party's seizure of control. Thus, every dollar collected by the debtor terminates a portion of the receivable, the remainder of which continues to be encumbered. The dollars actually collected are property of the debtor.

Seizure of control, according to this view, is not a transfer of debtor property.[296] Rather, it is a termination of the debtor's opportunity to disencumber the receivables through collection—the elimination of a condition subsequent on the secured party's preexisting property right. Unfortunately for mortgagees, it is precisely this termination that ultimately defeats a bona fide purchaser who has inherited the tenant's obligation to pay rent to the debtor. This implies that the mortgage is unperfected within the meaning of § 547(e)(1)(A).

Like all legal principles, it can be ignored. In *SLC Ltd. V v. Bradford Group West, Inc. (In re SLC Ltd. V)*,[297] Judge Judith Boulden applied § 547(e)(1)(A)'s definition of perfection in the context of a mortgage, but found that perfection meant recordation of the basic mortgage on the reversion.[298] "[T]he transfer that cut off a bona fide purchaser's rights," she wrote, "was the execution and recordation of the documents in 1986, outside the ninety day period prior to filing."[299]

Recordation of the mortgage, however, did not "cut off" the purchaser's right to collect rents prior to the dispossession of the purchaser following the debtor's default. The issue that Judge Boulden failed to address is whether the purchaser's *provisional* superiority proves that dispossession is an act of perfection.

295. *See* 11 U.S.C. § 547(e)(3) (1988).

296. *See* Financial Ctr. Assocs. v. TNE Funding Corp. (*In re* Financial Ctr. Assocs.), 140 B.R. 829, 831 (Bankr. E.D.N.Y. 1992) (Holland, J.). *Cf.* Sullivan v. Willock (*In re* Wey), 854 F.2d 196 (7th Cir. 1988), where a debtor lost a down payment in a real estate contract by not fulfilling the balance of the contract. Judge Michael Kanne ruled that no transfer occurred because the debtor "possessed *no rights* which he could transfer." *Id.* at 199. In other words, a condition subsequent to the creditor's ownership of the down payment (and accompanying equitable interest in the real estate) had failed, and such a failure is not a transfer.

But see Carlson v. Farmers Home Admin. (*In re* Newcomb), 744 F.2d 621 (8th Cir. 1984), discussed *infra* in the text accompanying notes 315-18.

297. 152 B.R. 755, 760-62 (Bankr. D. Utah 1993) (applying Utah law).

298. *See id.* at 760-62.

299. *Id.* at 764; *accord Financial Ctr.*, 140 B.R. at 831 (Bankr. E.D.N.Y. 1992).

On the definition of perfection offered up by § 547(e)(1)(A) it is very possible to say that a purchaser *can* obtain a superior right to real estate receivables. A purchaser takes over the right to collect rents until dispossessed by the secured party. To the extent that this right is exercised, the purchaser, not the secured party, owns the rents collected. The purchaser's superior right is, therefore, only temporary, but nevertheless superior. Thus, dispossession becomes a perfecting act within the meaning of § 547(e)(1)(A). This means that the timing rule of § 547(e)(2)(A) will rarely apply because the actual dispossession of the debtor will not, in general, take place within ten days of the creation of the mortgage lien.[300] Rather, either § 547(e)(2)(B) or § 547(e)(2)(C)[301] will apply. If so, the perfecting act of ending the debtor's power to collect establishes the time of the transfer.

So long as the hypothetical bona fide purchaser test in § 547(e)(1)(A) is applied according to its terms, a mortgagee rarely obtains the benefit of the timing rule in § 547(e)(2)(A). But, in their quest to prove that temporary inferiority over bona fide purchasers is real superiority, secured parties claiming real estate receivables can find support in cases involving purchase money security interests under Article 9 in which state law gives a longer grace period than the stingy ten days granted in § 547(e)(2)(A).[302] Cases have arisen in which the secured party missed the federal grace period, but nevertheless managed to perfect within the state law grace period. Ordinary intuition tells us that, because federal law preempts state law, the ten-day grace period of § 547(e)(2)(A) overrides the longer state-law period. As a result, only § 547(e)(2)(B) or (C) can apply. Accordingly, the secured party must be defeated for missing the federal grace period.[303]

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300. This timing rule may apply where the debtor and a new tenant sign a lease agreement less than ten days before the secured party dispossesses the debtor. *See infra* text accompanying notes 301-07.

301. *See* McCombs Properties VI, Ltd. v. First Tex. Sav. Ass'n (*In re* McCombs Properties VI Ltd.), 88 B.R. 261, 264-65 (Bankr. C.D. Cal. 1988) (Ryan, J.) (noting § 547(e)(2)(C)'s applicability in dictum).

302. *See, e.g.*, N.Y.U.C.C. LAW. § 9-301(2) (McKinney 1990) (employing a twenty-day grace period). In 1994, Congress amended § 547(c)(3)(B), to provide for a twenty-day grace period so that, if purchase money secured parties qualify for that defense to voidable preference lability, they need no longer be concerned with the timing rules in § 547(e)(2). *See* 11 U.S.C.A. § 547(c)(2) (West Supp. 1995).

303. For cases finding that § 547(e)(2)(A) overrides state law grace periods, see Howard Thornton Ford, Inc. v. Fitzpatrick (*In re* Hamilton), 892 F.2d 1230 (5th Cir. 1990); Wachovia Bank & Trust Co. v. Bringle (*In re* Holder), 892 F.2d 29 (4th Cir. 1989) (per curiam); Fitzgerald v. First Security Bank (*In re* Walker), 161 B.R. 484 (Bankr. D. Idaho 1993) (Pappas, J.), *aff'd*, No. 92-02863-7, 93-6020, § V 93-0498-E-EJL, 1994 WL 739698 (Bankr. D. Idaho, Oct. 26, 1994); Woodson v. City Fin. Co. (*In re* Holloway), 132 B.R. 771 (Bankr. N.D. Okla. 1991) (Wilson, J.).

A theory exists, however, that saves the purchase money secured party from the bad effect of this deferral. According to the federal definition of perfection in § 547(e)(1)(B) that applies to transfers of personal property, "a transfer of a fixture or property other than real property is perfected when a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee."[304] Some courts have read § 547(e)(1)(B) to mean that if the secured party successfully meets the state grace period, perfection relates back to the time of attachment; the security interest is simultaneously created and perfected.[305] According to Judge Stephen Covey, "The Bankruptcy Code does not say the physical act of perfection has to occur within ten days; it just states that the lien must be perfected within ten days."[306] On this view, § 547(e)(2)(A) always supplies the timing rule when a secured party meets a state grace period, but exceeds the federal period.[307]

If this controversial theory is applied to security interests on real estate receivables, § 547(e)(2)(A) applies after all, and secured parties can prevent avoidance of their security interests under § 547(b). If the theory is rejected and if the definition of perfection in § 547(e)(1)(A) requires dispossession of the debtor, then in many cases the security interest in rent receivables must be deemed transferred just before the bankruptcy petition.

In 1994, Congress amended § 547(e)(2)(A) to lengthen the grace period for purchase money security interests. Now, a ten-day grace period exists "except as provided in subsection (c)(3)(B)."[308] Section 547(c)(3)(B) was in turn amended to provide for a twenty-day grace period. This amendment seems aimed at accommodating the problem caused by many states having twenty-day grace periods for purchase money security interests while § 547(c)(3) or § 547(e)(2)(A) provided only ten-day grace periods. Therefore,

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304. 11 U.S.C. § 547(e)(1)(B) (1988).

305. *See* Webb v. General Motors Acceptance Corp. (*In re* Hesser), 984 F.2d 345 (10th Cir. 1993) (Campos, J.); General Motors Acceptance Corp. v. Busenlehner (*In re* Busenlehner), 918 F.2d 928, 931 (11th Cir. 1990) (per curiam) ("The general message to creditors is that should they follow state commercial law their secured loans will be protected in bankruptcy."), *cert. denied*, 500 U.S. 949 (1991); Beaumont v. General Motors Acceptance Corp. (*In re* Power), 133 B.R. 242, 244 (Bankr. N.D. Okla. 1991) (Covey, J.); Jahn v. First Tenn. Bank (*In re* Burnette), 14 B.R. 795 (Bankr. E.D. Tenn. 1981) (Kelley, J.).

306. *Beaumont*, 133 B.R. at 244.

307. The theory has been harshly criticized. *See, e.g., Walker*, 161 B.R. at 499; *Holloway*, 132 B.R. at 774 (stating that the cases supporting this theory "effectively read the statutory language 'within 10 days' to mean 'within 10 days plus some variable period of time as may be added thereto by State laws'"); Rutledge v. First Nat'l Bank (*In re* Carson), 119 B.R. 264, 267 (Bankr. E.D. Okla. 1990) (Ryan, J.) ("other sections of the Code make express reference to state law grace periods and thus we must consider that the failure of Congress to do so . . . was cognizant"); Irving A. Breitowitz, *Article 9 Security Interests as Voidable Preferences*, 3 CARDOZO L. REV. 357, 398 (1982).

308. 11 U.S.C.A. § 547(e)(2)(A) (West Supp. 1995).

it may be argued that Congress has now given all the solicitude to state law grace periods that it cares to give. Accordingly, obtainment of a receiver within a state law grace period cannot automatically invoke the rule of § 547(e)(2)(A). Rather, the rule of § 547(e)(2)(B) or (C) will apply, and the security interest will be deemed a transfer just prior to the bankruptcy.

Even though the choice of the timing rule goes against the secured party, several other reasons cast doubt on whether a security interest on rent receivables will be a voidable preference.

2. Insolvency

Loosely speaking, voidable preferences are transfers of debtor property made shortly before bankruptcy when the debtor is insolvent.[309] Yet, in a typical commercial real estate case, the secured party has an interesting argument that the typical single-asset debtor is never insolvent as required by § 547(b)(3). If correct, the mortgagee always escapes voidable preference liability.

It is assumed that the typical single-asset Chapter 11 real estate case entails the following features: The debtor is a partnership, and the mortgage is almost always nonrecourse. These features are demanded by tax considerations.[310] In a typical real estate failure, the mortgagee is by far the dominant creditor. Often, a few trade creditors exist, but their claims are small. These trade creditors have recourse to the general partners under state partnership law. Such a debtor is likely to be considered solvent under the special definition that Bankruptcy Code § 101(32)(B) gives for partnership entities. Section 101(32)(B) defines partnership insolvency as

> financial condition such that the sum of such partnership's debts is greater than the aggregate of, at a fair valuation—
> (i) all of such partnership's property . . . ; and
> (ii) the sum of the excess of the value of each general partner's nonpartnership property . . . over such partner's nonpartnership debts.[311]

Because the mortgage is nonrecourse, the mortgagee's claim is inherently equal to the value of the collateral, and the trade creditors claims are usually trivial. The assets consist of the single asset, equal to the nonrecourse mortgagee's claim, plus the surplus assets of the general partners after their

309. *See* 11 U.S.C. § 547(b) (1988).
310. *See supra* note 14 and accompanying text.
311. 11 U.S.C. § 101(32)(B) (Supp. V 1993).

nonpartnership debts are covered. The partnership assets, therefore, are likely to exceed the partnership debts.

This conclusion, however, rests on an assumption that should be made explicit. Notice that the definition in § 101(32)(B) includes net general partner assets as a component of the partnership's estate. Under state law, the partnership would not own a right over against the partners. Yet, § 723(a) gives a bankruptcy trustee the right to pursue the general partners in the name of the recourse creditors. Therefore, it appears that, loosely speaking, the definition of insolvency includes postpetition property of the estate in order to determine prepetition insolvency. Because it does so, the typical real estate Chapter 11 case will involve a solvent debtor.

If the trustee's postpetition right under § 723(a) is an asset of the partnership for the purpose of calculating prepetition insolvency, then perhaps it is fair to count postpetition liabilities of the partnership as well. Thus, if the debtor files in Chapter 11, which is universally the case in single-asset real estate bankruptcies, the nonrecourse creditor gets artificial recourse under § 1111(b)(1)(A) in the Chapter 11 proceeding. If this postpetition artificial recourse is also counted as a prepetition debt of the partnership, then many single-asset partnerships are radically insolvent prior to bankruptcy. In some cases, general partners will have wealth sufficient to cover this claim. But the general partners are never personally liable to pay the artificial recourse claim. Only the bankrupt partnership has this liability.[312]

The definition of partnership insolvency includes the postpetition asset of § 723(a) liability, but it says nothing about the postpetition liability under § 1111(b)(1)(A). This omission may lead teutonically minded courts to conclude that whatever is not permitted must be forbidden. On this view, real estate partnerships are likely to be found solvent, and any payments to the secured party will not be voidable preferences.

In *Union Meeting Partners v. Lincoln National Life Insurance Co. (In re Union Meeting Partners)*[313] Judge David Scholl found that a single-asset partnership debtor was solvent in a case where the general partners had

312. *See In re* Greystone III Joint Venture, 102 B.R. 560, 570 (Bankr. W.D. Tex. 1989) (Clark, J.) (finding the partners of debtor not liable to a nonrecourse secured party in Chapter 11), *aff'd*, 127 B.R. 138 (W.D. Tex. 1990), *rev'd on other grounds*, 995 F.2d 1274 (5th Cir. 1991), *cert. denied*, 113 S. Ct. 72 (1992). In the preceding remarks, it is important not to confuse the requirement of insolvency in § 547(b)(3) with the hypothetical liquidation test in § 547(b)(5), which posits a hypothetical Chapter 7 proceeding. In the hypothetical Chapter 7 proceeding, the recourse claim under § 1111(b)(1)(A) does not exist, but this is, by itself, no reason to conclude that the obligation cannot exist for calculating a partnership's insolvency. If the secured party may count the § 723(a) right as an asset of the debtor—an asset that also exists in Chapter 11, *see* Carlson, *Classification Veto*, *supra* note 7, at 586-87 the secured party must also count the artificial obligation of the chapter 11 debtor as well. Alternatively, neither should be counted; the debtor probably is insolvent when only state law property rights are considered.

313. 163 B.R. 229, 239-40 (Bankr. E.D. Pa. 1994).

substantial net wealth. In doing so, he implicitly included the partners' net assets and the artificial recourse claim in the calculation. Nevertheless, the general partners' net wealth was such that, even after adding the artificial recourse claim, the partnership was solvent at all times, and the mortgagee was innocent of voidable preference liability. In a different case, however, the artificial recourse claim, if counted as a liability, could render the partnership entity insolvent.

3. *The Hypothetical Liquidation Test*

Many courts are committed to the idea that security interests on rent receivables are not perfected until the secured party dispossesses the debtor, or at least serves the notice on the bankruptcy trustee that § 546(b) requires. Such a view is plausible because a hypothetical bona fide purchaser of the debtor could collect rents free and clear of the mortgage lien until the lien creditor is dispossessed.

If the transfer is deemed to occur just before bankruptcy, the secured party might escape liability by grace of the hypothetical liquidation test in § 547(b)(5). Section 547(b)(5) provides that a transfer is a voidable preference if it

> enables such creditor to receive more than such creditor would receive if—
> (A) the case were a case under Chapter 7 of this title;
> (B) the transfer had not been made; and
> (C) such creditor received payment of such debt to the extent provided by the provisions of this title.[314]

When the secured party has not actually collected rents prior to the filing of the bankruptcy petition, the security interest on the rent receivables is not preferential within the meaning of the test. Suppose that (A) we pretend the case was a Chapter 7 case, (B) we pretend that the security interest on the rent receivables had not been made, and (C) we calculate that the secured party would be entitled to sell the debtor's reversionary interest in real estate because the mortgage is recorded and valid. The case law of § 547(b)(5) insists that no time pass between the start of the hypothetical Chapter 7 case and the hypothetical distributions that such a case would generate.[315] Because the secured party would receive the value of the reversionary interest in the hypothetical Chapter 7 liquidation anyway and because that is all the

314. 11 U.S.C. § 547(b)(5) (1988).

315. *E.g.*, Neuger v. United States (*In re* Tenna Corp.), 801 F.2d 819 (6th Cir. 1986) (Jones, J.); *see also* Carlson, *supra* note 25.

secured party has received in reality, the bankruptcy trustee cannot show that the test in § 547(b)(5) is violated.

The matter is different, however, when the secured party has actually collected some rent prior to the bankruptcy petition. These collected rents establish that the secured party received more from actual transfers than would have been received from a hypothetical Chapter 7 liquidation. Accordingly, at least the rents actually collected are voidable.

One case that solved a similar dilemma by hypothetical liquidation test is *Carlson v. Farmers Home Administration (In re Newcomb)*,[316] where the debtor and creditor set up an escrow fund to cover the amount of a judgment in favor of the creditor. The fund would go to the creditor if the creditor survived an appeal. Otherwise, it would revert to the debtor. The escrow was created before the ninety-day preference period, but the creditor's victory on appeal occurred within the preference period.

The proper way to view *Newcomb* is that the debtor transferred funds to the creditor, via the escrow, more than ninety days before the bankruptcy. Appellate victory was no transfer at all, but was instead the elimination of a condition subsequent that, if fulfilled, would have vested the debtor with the funds once again.

This is not how Judge William C. Hanson chose to analyze the matter. He thought that the Bankruptcy Code's definition of transfer was "broad enough to include both the transfer that occurs when an escrow is created and the transfer that occurs when the condition of an escrow is met."[317] Two transfers occurred, and the court had to choose which one counted. This interpretation was the result of the judge's confusion regarding the termination of a condition subsequent and the transfer of property.[318] Nevertheless,

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316. 744 F.2d 621 (8th Cir. 1984).

317. *Id.* at 626.

318. *See* Carlson, *supra* note 25, at ___. To call the disappearance of a condition subsequent a transfer is not entirely implausible if property is defined in the Hohfeldian manner as a concatenation of rights, immunities, privileges, and powers. Hohfeld would say that the termination of the debtor's power to collect rents is also the creation of the secured party's immunity from this power. One of the sticks in the debtor's bundle has disappeared, and the correlative stick has simultaneously appeared in the secured party's bundle. But Hohfeldian analysis is not absolutely imposed by the Bankruptcy Code, in spite of a breathtakingly broad definition of transfer. 11 U.S.C. § 101(54) (Supp. V 1993) (defining a transfer as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing or of parting with property or with an interest in property, including retention of title as a security interest. . . ."). Read literally, every time the debtor does not exercise a stock option by the contract deadline, the debtor has transferred the underlying stock to the person who sold the option because the debtor failed to exercise it. *But see* Allan v. Archer-Daniels-Midland Co. (*In re* Commodity Merchants, Inc.), 538 F.2d 1260, 1263-64 (7th Cir. 1976) (finding expiration of option not to be a transfer). Such a view would upset the stock market even more than the triple witching hour. It is best to say, if only on consequentialist grounds, that the termination of a condition subsequent, contrary to Judge Hanson's view, simply is not a transfer. Therefore, it

Judge Hanson's analysis put him in the position of having to assess the effect of the hypothetical liquidation test on a transfer that was artificially deemed to occur just before bankruptcy. According to Judge Hanson:

> [t]he transfer that occurred when the condition of the escrow was met is not the type of transfer that can be avoided. To be avoidable a transfer must deprive the debtor's estate of something of value which could otherwise be used to satisfy creditors. Once the escrow was created, the only interest in the escrowed funds remaining in the debtor was a contingent right to the funds if . . . the judgement [was reversed]. This interest is worthless in light of . . . [the] affirmance of the judgment . . . . Therefore, the "transfer" of this interest did not deprive the estate of anything of value. It follows that this "transfer" cannot be avoided.[319]

Thus, the later transfer is not avoidable because it did not diminish the debtor's estate. Presumably, this reference to diminution was meant to invoke the hypothetical liquidation test of § 547(b)(5). According to this test, a transfer is preferential only to the extent that the transfer allows the secured party to obtain more than would have been obtained if the transfer had been foregone in favor of the dividend a hypothetical Chapter 7 liquidation would have produced.

Judge Hanson's formulation worked to defeat the trustee in *Newcomb*. Under the hypothetical liquidation test, if the debtor had lost or abandoned the appeal, the secured party would have obtained all the funds in escrow in the hypothetical Chapter 7 liquidation proceeding called for in § 547(b)(5). Because the secured party would have received the same amount in the hypothetical bankruptcy as the party actually received, the transfer was not preferential.

This approach works with regard to security interests on rent receivables when the secured party has not actually collected any rents. In Such a case, the secured party has not received more from her security interest on rent receivables than she would have received in the hypothetical chapter 7 liquidation. This approach does not work, however, if some rents were actually collected. Suppose that a mortgagee has succeeded in capturing the right to collect rents before bankruptcy and has actually collected some. Such a transfer always meets the hypothetical liquidation test. In a hypothetical Chapter 7 liquidation, the secured party would obtain the value of the reversion. In real life, the secured party will have obtained whatever rents were collected plus the value of the reversion. Therefore, any actual

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is assumed that the disappearance of a condition subsequent is not a new transfer of debtor property.

319. *Newcomb*, 744 F.2d at 626-27 (citation omitted).

dispossession that resulted in collections by the secured party would fall afoul of § 547(b)(5).[320]

In the end, even if the trustee can make out all the elements of a voidable preference, the trustee's victory is Pyrrhic at best because the fundamental nature of all avoidance theories is that they are mere adjuncts to the trustee's strong-arm power, a step usually skipped because it rarely makes a difference. But, with regard to security interests on rent receivables, this theory makes all the difference.

4. *Consequences*

If it is decided that dispossessing the debtor is a perfecting act, the security interest on rent receivables is usually a voidable preference. Many will think that the trustee can, therefore, continue to collect rents during the pendency of the bankruptcy proceeding. This would be a mistake.

Instead, a deep inquiry into the concept of avoidance prevents this result. If the trustee can avoid a transfer, the transfer is treated as if the debtor never transferred it. But the way the *trustee* obtains this "debtor" property is by the transfers described by the strong-arm power.

This theory of bankruptcy avoidance can be elaborated.[321] Even if we imagine the voidable security interest to be avoided, we are left with the proposition that the debtor owns the would-be collateral free and clear of the avoided encumbrance. This property enters the bankrupt estate, but the nature of the transfer from the debtor to the bankruptcy trustee is described by the strong-arm power. In other words, avoidance sets aside the otherwise valid transfer, but the trustee's strong-arm power brings the property into the bankrupt estate. Avoidance under § 547(b) simply supplements the strong-arm power. Accordingly, avoidance of the assignment of rents allows the bona fide purchaser to claim the collateral as a transferee with rights superior to that of the avoided lien.

So conceived, the trustee becomes a purchaser[322] or lien creditor of the

320. This was heavily implied by Judge David Scholl in Union Meeting Partners v. Lincoln Nat'l Life Ins. Co. (*In re Union Meeting Partners*), 163 B.R. 229, 236-37 (Bankr. E.D. Pa. 1994). In that case, very shortly before bankruptcy, a secured party had served notice on the tenants that, henceforward, they were to pay the secured party directly. According to Judge Scholl, the debtor's power to collect free and clear of the security interest constituted a property interest, which the debtor "transferred" when the secured party terminated the debtor's power to collect. Judge Scholl indicated that, if any prepetition rents had actually been collected, the rents would have to be returned as voidable preferences. *Id.* at 237 & n.2. On the facts, however, Scholl decided that no prepetition rents had been collected, and so there were no voidable preference recoveries. *Id.*

321. For a more complete account of this theory, see Carlson, *supra* note 255, at 855-63.

322. For a case denying that trustees can hypothesize themselves as mortgagees, see United States v. Farrell (*In re* Fluge), 57 B.R. 451, 456 (Bankr. D.N.D. 1985) (Hill, J.). Although

rent receivables. This reinstitutes all that has been previously explained with regard to the strong-arm power. Thus, the trustee has a temporary right to disencumber rent receivables by collecting them, a right that the secured party can terminate by sending the notice required by § 546(b).

At the heart of this theory is the notion that avoidance sets the stage for a creditor or, in the case of federal bankruptcy law, the trustee to attach a lien to the property subject to the avoided transfer. By the way of analogy, under the Uniform Fraudulent Conveyance Act, a defrauded creditor may avoid a transfer by having it set aside or by disregarding it and establishing a judicial lien as if the property still belonged to the debtor.[323] The avoiding creditor, however, must still proceed to obtain a judicial lien on the fraudulently conveyed property. Similarly, it is never enough for the trustee to avoid a transfer under § 547. Rather, the trustee must bring it into the estate via the strong-arm power under which the trustee is either a judicial lien creditor or a bona fide purchaser of real estate.[324]

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nothing seemed to turn on this question in *Fluge*, it is wrong that trustees cannot imagine themselves as mortgagees. Rather, trustees can imagine themselves to be any sort of purchaser if that will aid in the avoidance of some defective transfer. Moreover, the hypothesis of a mortgagee is essential under some fact scenarios. For example, suppose the debtor owes $1 million dollars on a nonrecourse mortgage and the property is worth $500,000. Suppose there are only $10,000 in other unsecured claims. The mortgage is unrecorded and, therefore, invalid under the strong-arm power. If this is so, the nonrecourse mortgagee would have no claim in the bankruptcy, secured or unsecured, without the mortgagee's claim. The debtor would be technically solvent. Arguably, the trustee should avoid the mortgage only to the extent of $500,000, the value of the property, and return the balance of the mortgage to the nonrecourse mortgagee. This is easy to imagine if the trustee is a hypothetical mortgagee representing $500,000 worth of creditor claims. Alternatively, if the trustee is the outright buyer of fee simple absolute, there is no way to explain how the nonrecourse mortgagee has any right to the surplus after the creditors are paid.

323. UNIF. FRAUDULENT CONVEYANCE ACT § 9, 7A U.L.A. 577-78 (1985).

324. Some objections can be made to this general theory of avoidance. First, the trustee recovers not through the strong-arm power but through § 550(a), which permits the trustee to recover "the property transferred, or, if the court so orders, the value of such property." 11 U.S.C. § 550(a) (1988). Therefore, even if no strong-arm theory exists, so long as the transfer is a voidable preference, the trustee can recover property—no questions asked. Furthermore, § 541(a)(3) makes clear that any property recovered is property of the estate. *See id.* § 541(a)(3). All of this is without regard to the trustee's strong-arm power in § 544(a).

A few responses are available to this challenge. First, § 550(a) is not the exclusive mode by which avoidance powers are exercised. For example, § 548(a)(1) calls for the avoidance of transfers and obligations, *see id.* § 548(a)(1) while § 550(a) speaks solely of transfers, *see id.* § 550(a). If § 550(a) were the exclusive portal through which avoidance powers must pass, then how could obligations be avoided under § 548(a)? Second, an historical inquiry reveals that § 550(a)(1) was added principally to make clear that the value of transfers—not the transfers themselves—can be recovered. Old § 60(b) of the Bankruptcy Act, in contrast, provided only for the recovery of transfers, or, in case of conversion, the value of the transfer from the converter. *See* Bankruptcy Act of 1898, ch. 575, § 60(b), 52 Stat. 840, 870 (1938) (repealed 1978). Meanwhile, § 60(a) made liable non-transferees who merely benefitted from the transfer.

On this admittedly arcane, but nonetheless logical, reasoning, security interests in rents may routinely be voidable preferences. But the exploitation of avoidance is by means of the strong-arm power. Hence, the bankruptcy trustee can never exploit the voidable preference theory beyond the reach of the strong arm power. The strong-arm power might temporarily subordinate the security interest on the rent receivables,[325] until the secured party serves the repossessory notice described in § 546(b),[326] but it can never totally avoid the security interest. Voidable preference theories add nothing to this inherent limitation on the trustee's ability to disencumber rent receivables.

5. *After-Acquired Leases*

Suppose a debtor grants a new lease within the preference period; one receivable has ended, and another has been created. According to some authorities, the bare mortgage lien on the reversion does not attach to after-acquired leases.[327] Thus, Judge Bruce Fox writes, "Such lessees are viewed not in privity with the mortgagee, and the mortgagee is limited to ejecting the

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No theory existed to explain how a nontransferee might be liable under § 60(a). Bankruptcy Act of 1898, ch. 70, § 60(a), 64 Stat. 24, 25 (1950) (repealed 1978). This gave rise to the notorious "two-transfer" theory, which was used to justify recovery from the beneficiary. Under this theory, the benefit was called a transfer, thereby justifying recovery under § 60(b). The principal utility in adding § 550(a), then, was to explain in a more satisfactory way why beneficiaries should have to pay for a transfer they never received. Section 550(a) was not meant to change the status of the avoided recovery itself.

Because of this history, § 550(a) does not uniquely mediate voidable preference recoveries. Rather, the strong-arm power does. Suppose a debtor owes fifty dollars and gives away his only asset, a hundred dollar painting, so that the creditors cannot get it. The gift is a fraudulent transfer under § 548(a)(2). The bankruptcy trustee can only avoid the transfer and then impose the hypothetical judicial lien on it. The hypothetical judicial lien amounts to fifty dollars. Therefore, the trustee may recover the painting and sell it, but the trustee can only recover fifty dollars. The rest is a surplus that necessarily belongs to the donee. This example proves that a trustee can only avoid the transfer *to the extent* of the strong-arm power. *See* Note, *Fraudulent Conveyance Law as a Property Right*, 9 CARDOZO L. REV. 843 (1987). *But see* Acequia, Inc. v. Clinton (*In re* Acequia, Inc.), 34 F.3d 800, 811-12 (9th Cir. 1994) (concluding that any recovery may be retained).

325. This conclusion accords with the result, if not the reasoning, in Union Meeting Partners v. Lincoln Nat'l Life Ins. Co. (*In re Union Meeting Partners*), 163 B.R. 229 (Bankr. E.D. Pa. 1994). Judge Scholl conceded that rents actually collected by the secured party before bankruptcy might be preferential, but the mortgage on the reversion was not at risk. Scholl reasoned that since the mortgage on the reversion was recorded, the mortgage must be good. *Id.* at 235-36. A more complete analysis is that the trustee's right to collect rent in light of this recorded mortgage is limited or, on the expansive view of adequate protection, non-existent.

326. The ability of a secured party to overthrow the tyranny of the strong arm power by serving notice under § 546(b) is discussed *supra* in the text accompanying notes 255-71.

327. *See* GEORGE E. OSBORNE ET AL., REAL ESTATE FINANCE LAW §4.25 (1979); Kratovil, *supra* note 93, at 9-10; Yale Note, *supra* note 91, at 1434-35.

tenant (whether or not the lessee is in default) or to creating a new lease agreement with the lessee."[328] Judge Fox thought that if the mortgage contains an express assignment of rents, the assignment is capable of attaching to after-acquired rent receivables.[329] In contrast, Judge David Scholl, also interpreting Pennsylvania law, thought that a mortgage agreement containing an express assignment was not competent to encumber after-acquired receivables.[330]

Assuming that the mortgage lien attaches to the after-acquired rent receivable, the security interest on such a receivable is deemed transferred to the secured party only when the receivable comes into existence. Section 547(e)(3) states, "For the purposes of this section, a transfer is not made until the debtor has acquired rights in the property transferred."[331] Why should this new real estate receivable not be deemed a transfer within ninety days to a secured party? If the secured party is undersecured, the transfer might be a voidable preference.

There are at least two possible reasons to think that no voidable preference has occurred.[332] First, all voidable preference recoveries must be assessed according to the strong-arm power.[333] Therefore, even if the security interest on the after-acquired rent receivable is a voidable preference, this only means that the trustee's hypothetical bona fide purchase attaches to the receivable. The mortgagee's postpetition perfection under § 546(b) can take back this status.

Second, even if the strong-arm theory is rejected, § 547(c)(5) may defend the security interest on the after-acquired rent receivable. The rent receivable created within the preference period is a "receivable" within the meaning of

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328. *In re* Wynnewood House Assocs., 121 B.R. 716, 722 (Bankr. E.D. Pa. 1990); *accord In re* Prichard Plaza Assocs. Ltd. Partnership, 84 B.R. 289, 299 (Bankr. D. Mass. 1988).

329. 121 B.R. at 721.

330. *See In re* TM Carlton House Partners, Ltd., 91 B.R. 349, 355 & n.1 (Bankr. E.D. Pa. 1988). In support of this proposition, Scholl cited Teal v. Walker, 111 U.S. 242 (1884), in which Justice Edward Burnham Woods wrote:

> Where, however, the lease is subsequent to the mortgage, the rule is well settled in this country, that, as no reversion vests in the mortgagee, and no privity of estate or contract is created between him and the lessee, he cannot proceed, either by distress or action, for the recovery of the rent.

Id. at 248 (citations omitted).

331. 11 U.S.C. § 547(e)(3) (1988).

332. One insufficient reason is the observance that the lease is proceeds of real estate. The creation of proceeds is always a transfer of property from the debtor to the secured party. If the secured party has given up collateral in exchange for its new security interest in proceeds, perhaps the secured party has a voidable preference defense under § 547(c)(1). Such a theory cannot work in a real estate case, where the secured party has likely given nothing up. The new receivable is entirely an improvement in position.

333. *See supra* text accompanying notes 256-78.

§ 547(a)(3), which broadly defines it to be a "right to payment, whether or not such right has been earned by performance."[334] Therefore, a secured party might be entitled to the defense in § 547(c)(5).

According to this defense, all perfected security interests in receivables are defended unless the secured party's position has improved across the preference period. Improvement of position is tested by subtracting the secured claim from the value of "all security interests" that existed at the start of the preference period.[335] This is then compared to the like insufficiency on the day of the filing of the bankruptcy petition. If the insufficiency has shrunk, the secured party's position has improved; the defense is withdrawn to the extent of the improvement of position.[336]

Even so, the improvement in position brings grief only if it is "to the prejudice of other creditors."[337] This has been interpreted as expenditure of unencumbered assets to improve the value of the secured party's collateral. In a real estate case, any rents the debtor collects have been disencumbered and are property that the unsecured creditors might get in bankruptcy. If the debtor spends these dollars in generating or maintaining the new lease, then, to that extent, the unsecured creditors have been prejudiced. This is ironic because the unencumbered dollars are proceeds of collateral that the secured party owns. Ordinarily, the release of cash proceeds occurs contemporaneously with or after the secured party receives a proceeds security interest. Here, disencumbrance of the cash collateral occurs *before* the new lease is obtained, thereby depriving the secured party of voidable preference defenses.[338]

On the above analysis, the secured party is immune from voidable preference liability for leases signed during the preference period because either the leases do not improve the secured party's position or because any improvement in position is barely to the prejudice of the creditors. Only if the debtor spends special identifiable amounts on landing a tenant have the unsecured creditors been prejudiced.

Another reason, rather unconnected from the statutory language of § 547(b), why voidable preference law should have no grievance against leases granted during the ninety-day period is that postpetition leases belong to the

334. 11 U.S.C. § 547(a)(3) (1988).

335. When the mortgage itself was created during the preference period for new value, the relevant date is not the start of the preference period, when zero claim would be subtracted from zero collateral, but rather "the date on which new value was first given under the security agreement creating such security interest." 11 U.S.C. § 547(c)(5)(B) (1988).

336. Carlson, *supra* note 25, at ___.

337. 11 U.S.C. § 547(c)(5) (1988).

338. Section 547(c)(1) requires that the parties intend a contemporaneous exchange, *see* 11 U.S.C. § 547(c)(1) (1988), which will not be the case here. Section 547(c)(4) requires that new value be extended *after* the secured party has received a voidable preference. *See id.* § 547(c)(4) (1988).

secured party under § 552(b) to the extent the equities exception does not apply.[339]

VII. CONCLUSION

Few legal subjects are in the advanced state of disarray enjoyed by the law of security interests on rent receivables. The confusion arises from the fact that (1) courts have made metaphoric errors with regard to the absolute assignment of rents, taking "absolute" to mean that the debtor has forfeited rent receivables to secured creditors—forfeitures that § 541(c)(1)(B) and probably state law independently prevent; (2) courts are deeply divided as to when a secured creditor's right to adequate protection starts; and (3) courts are disparate in applying the avoidance powers against a security interest that is temporarily junior to bona fide purchasers of the underlying real estate.

On this last issue, procreditor courts, offended by real estate entrepreneurs trying to extend their tax shelters through abuse of Chapter 11, have tried to put an end to the avoidance powers by proclaiming that termination of the debtor's power to disencumber rent receivables is "enforcement," not "perfection." Furthermore, courts have noted that "perfection" generally means public recordation and that security interests in rent receivables should be deemed perfected as they are recorded. Conversely, because these security interests cannot be permanently avoided, they must perforce be totally valid. These conclusions, illegitimately obscure the truth that a bona fide purchaser or lien creditor, in most states, temporarily disencumbers a rent receivable from the recorded security interest by collecting.

These opinions can be viewed sympathetically as protests against a bankruptcy law that has degenerated into gamesmanship. Security interests rise and fall on bureaucratic acts that serve no purpose except to establish that the bankruptcy trustee ought to lose and the secured creditor ought to win with regard to specific collateral. It is unsatisfactory that secured parties should be put to the meaningless ritual of meeting postpetition grace periods. It should be apparent that the typical secured party wants maximum rights in bankruptcy. Why make the secured party jump through meaningless hoops to perfect the security interest? Why not save them the trouble? This is what courts have done in proclaiming that the termination of the debtor's power to disencumber rents is enforcement, not perfection. The instinct may be admirable, but the legal reasoning that accompanies it is not.

If it is useless bureaucracy to make secured creditors claiming rent receivables take some postpetition action to trigger their right to adequate protection, this same critique can be made of § 546(b) in general. This subsection was written primarily with purchase money secured parties and

339. *See* Oliver v. MBank Dallas, N.A. (*In re* Oliver), 66 B.R. 426 (Bankr. N.D. Tex. 1986); Donahue & Edwards, *supra* note 54, at 678-79.

mechanics' lienors in mind. Why should those parties have to live up to the bureaucratic requirements of postpetition perfection? Are not their burdens just as useless?[340] Unfortunately, the legislative history is far too clear for these secured creditors to win relief from § 546(b).

Section 546(b) exists to force unperfected secured parties to jump through postpetition hoops. One argument holds justifying this state of affairs is that state law has given too much power to secured creditors. By hindering secured creditors with bureaucratic requirements, some admittedly ad hoc justice can be done through the art of ambush. This is, of course, nothing but the time honored principle—privately admired though publicly scorned—that two wrongs do indeed make a right.

On the view that it is up to Congress to make debtor-creditor policy and that bankruptcy courts should follow the law, it is clear that in many states security interests in rent receivables are temporarily unperfected, but when perfected postpetition, perfection validly relate back to the time that the security interests first attached to the rent receivables.

The law would appear more rational if Congress would address more cogently the status of security interests on rent receivables. Congress made an attempt to do so in the 1994 amendments to § 552(b), but Congress made it clear that the right to proceeds still had to pass through the gauntlet of the trustee's strong-arm power. In these amendments, Congress said that, "notwithstanding section 546(b)," the security interest on proceeds is valid.[341] This may have been an attempt to declare that, once a mortgage is recorded, the assignment of rents should be fully honored in bankruptcy. Unfortunately, the draftsmanship is so poor that courts might draw the opposite conclusion—that the strong-arm power prevails "notwithstanding" the debtor's attempt to comply with a state grace period under § 546(b). As often happens, Congress's amendment to § 552(b) may have done nothing but complicate further the law of rents in bankruptcy proceedings.

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340. It has been suggested that secured parties should, in general, prevail in bankruptcy whenever the bankruptcy petition bifurcates a grace period under state law. *See* Carlson, *supra* note 25, at ___.

341. *See supra* text accompanying notes 38-42.