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An Agricultural Law Research Article

## **Perfecting a Security Interest in Future Rents from Mortgaged Property**

by

Keith D. Haroldson

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# PERFECTING A SECURITY INTEREST IN FUTURE RENTS FROM MORTGAGED PROPERTY

*Keith D. Haroldson\**

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## I. INTRODUCTION

When a period of time dominated by rising agricultural land prices ends, the frenzy of borrowers and lenders attempting to capitalize on the increasing land values also ends. In a period of rising prices, loans are made and mortgages are granted with little consideration given to possible defaults. Optimism overshadows the possibility of foreclosures. During a time of rising prices, the borrowers and lenders are "partners," with each benefiting from an extension of credit to purchase land. However, when decreasing land values no longer support the outstanding debt, a line is "drawn in the dirt" and borrowers and lenders face each other as adversaries.

During a period of decreasing land values, the interpretation and application of statutes and case law concerning debtor-creditor relations are given great attention. The courts are asked to draw the "line in the dirt" as clear as possible so lenders, borrowers, and their representatives can be sure of their respective rights and the necessary steps to secure these rights.

One example of this line drawing occurred during the agricultural credit crisis of the 1980s when "[t]he value of agricultural real estate escalated from \$216 billion in 1970 to \$767 billion in 1980 and then crashed."<sup>1</sup> A legal issue arising from this credit crisis was the extent of the security created in

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\* B.S., Iowa State University; J.D., Drake University; Member: Iowa Bar; Associate: Grefe & Sidney, Des Moines, Iowa.

1. Easterbrook, *Making Sense of Agriculture: A Revisionists Look at Farm Policy*, in *IS THERE A MORAL OBLIGATION TO SAVE THE FAMILY FARM?* 13 (G. Comstock ed. 1987).

a mortgage that contains language granting the mortgagee an interest in the rents and other profits from the encumbered property.<sup>2</sup> The Iowa Supreme Court recently addressed the issue of a mortgagee's lien on cash rent from encumbered land in *Federal Land Bank v. Lower*.<sup>3</sup> Although the court answered the question regarding the creation of the security interest in the rents from encumbered property,<sup>4</sup> the court left another important question unanswered: How does a mortgagee perfect its interest? While it is valuable to know one's rights, they are of little consequence without a method to secure them. Thus, it is important to note the developments in the area of perfecting a mortgagee's interest in cash rent from the mortgaged property.

This Article begins by reviewing conventional methods by which a mortgagee creates an interest in the rents and profits from mortgaged property. Next, the discussion focuses on previous methods for perfecting such an interest and how those methods have changed. Finally, attention is given to the judicial activity regarding conflicting claims that arise when a third party is given an interest in the mortgaged property.

## II. CREATING THE INTEREST TO BE PERFECTED

Iowa Code section 557.14 provides: "In [the] absence of stipulations to the contrary, the mortgagor of real estate retains the legal title and right of possession thereto."<sup>5</sup> The language "stipulations to the contrary" allows the creation of an interest in favor of the mortgagee out of the mortgagor's full possessory right. Stipulations to which the parties agree are most commonly made a part of the mortgage.<sup>6</sup>

There are several different ways the interest can be created. The language of the mortgage may *grant* the interest in a revenue and income provision. As an example, the mortgagee may be granted a security interest in "[a]ll rents, issues, profits, leases, condemnation awards and insurance proceeds now or hereafter arising from the ownership, occupancy or use of the [property]."<sup>7</sup> This is similar to the mortgage terms used by the parties in

2. An agricultural credit crisis also involves the policy issues of whether public intervention would be appropriate or helpful, and the manner in which intervention efforts should be developed. Harl, *The Architecture of Public Policy: The Crisis in Agriculture*, 34 U. KAN. L. REV. 425, 426 (1986).

3. *Federal Land Bank v. Lower*, 421 N.W.2d 126, 128 (Iowa 1988); see also *infra* text accompanying notes 38-40.

4. *Federal Land Bank v. Lower*, 421 N.W.2d at 128.

5. IOWA CODE § 557.14 (1987); see also *infra* text accompanying note 17.

6. See IOWA CODE § 622.32 (1987). Iowa's statute of frauds requires a contract creating or transferring an interest in lands must be in writing and signed by the party to be charged. *Id.* Reducing the stipulations to writing incorporates the stipulations into an enforceable contract and serves as evidence of the nature of the interest created in favor of the mortgagee.

7. This example is representative of a typical mortgage provision that grants an interest in the rents and profits from mortgaged property and is found in Iowa Bar form number 128 as published by the Iowa Bar Association.

*Lower*.<sup>8</sup>

The mortgage also may *pledge* the interest in rents from the land as security for payment of the debt. A typical mortgage clause pledging an interest in rents may read: "[T]he rents, and profits of said real estate are hereby pledged as security for the payment of said debt."<sup>9</sup>

A mortgage that contains a grant of future rents should be distinguished from a mortgage that contains a pledge. The court in *First-Trust Joint Stock Land Bank v. Blount*<sup>10</sup> illustrates the distinction:

In numerous decisions of this court we have held that a mortgage, such as that involved in this case, which does not convey the rents and profits in the granting clause, but merely pledges them in another part of the mortgage, does not constitute a chattel mortgage as to such rents and profits and does not create a lien upon the rents and profits prior to the filing of a petition for the foreclosure of the mortgage and a request for the appointment of a receiver.<sup>11</sup>

Recent opinions also recognize the distinction between a grant and a pledge.<sup>12</sup> A grant of rents creating a lien is characterized as *primary* security for the indebtedness,<sup>13</sup> but a pledge of rents is characterized as *secondary* security, requiring the request for the appointment of a receiver.<sup>14</sup>

A *receivership clause* can provide a final method by which a mortgagee obtains an interest in the rents from encumbered property. The clause may read: "And if suit is brought to foreclose this mortgage [the parties] hereby authorize the court to appoint a receiver, for the benefit of the mortgagee, of the rents, issues and profits."<sup>15</sup> The mortgagee, however, should not rely solely on the receivership clause for its security. The courts have taken the position that "the mortgagee of land has no right to have his security enhanced by the rents and profits of the real estate in the absence of a clause in the mortgage giving him this right in express terms or by necessary implication."<sup>16</sup> Because there would be no interest to assert without a grant or pledge, the importance of a well-drafted mortgage is obvious.

Once an interest is created, attention should turn to the method for

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8. *Federal Land Bank v. Lower*, 421 N.W.2d at 127.

9. *First-Trust Joint Stock Land Bank v. Blount*, 223 Iowa 1339, 1340, 275 N.W. 64, 65 (1937).

10. *Id.*

11. *Id.* at 1341, 275 N.W. at 66.

12. *See infra* notes 13-14.

13. *Federal Land Bank v. Lower*, 421 N.W.2d at 129.

14. *In re Hollinrake*, 93 Bankr. 183, 188 (Bankr. S.D. Iowa 1988); *see infra* notes 82-96.

15. *Whiteside v. Morris*, 197 Iowa 211, 213, 197 N.W. 56, 57 (1924).

16. Note, *Mortgage Receiverships in Iowa*, 27 IOWA L. REV. 626, 626-27 (1942) (citing *McBride v. Cromley*, 204 Iowa 622, 215 N.W. 613 (1927); *Iowa State Bank v. Rons*, 203 Iowa 51, 212 N.W. 362 (1927); *Young v. Stewart*, 201 Iowa 301, 207 N.W. 401 (1926)). The present Iowa statute states: "In the absence of stipulations to the contrary, the mortgagor of the real estate retains the legal title and right of possession thereto." IOWA CODE § 557.14 (1987).

perfecting that interest. A discussion comparing the previous methods of perfection to the method recently recognized by the courts is helpful.

### III. HISTORICAL PERSPECTIVE AND THE PROCEDURE FOR PERFECTION

Iowa is a lien theory state.<sup>17</sup> Under this theory, the lender does not receive a possessory interest in mortgaged land.<sup>18</sup> Title remains with the borrower and the lender receives a lien on the property.<sup>19</sup> Although the lender does not receive a possessory interest, the lender, in the event of default, is placed in a position of priority secured by the mortgaged land.

The lender's priority position may be questioned when the mortgagor leases the encumbered property to a third party. If the mortgage grants the mortgagee an interest in rents, the contractual language of the mortgage can be applied to settle any dispute between the mortgagor and the mortgagee.<sup>20</sup> The third-party lessee, however, is not a party to the mortgage and is not bound by the contractual grant. In fact, a third-party lessee may not have realized the leased property was subject to a mortgage. Thus, a system to put a third party on notice was needed.

In response to this need, the Iowa legislature provided for the permissive cross-indexing of a recorded real estate mortgage into a chattel mortgage index.<sup>21</sup> Section 1 of the Iowa Acts, chapter 246 reads in part: "Where in a real estate mortgage there is any provision creating an encumbrance . . . [the mortgage may be] recorded at length, and also indexed in the chattel mortgage book."<sup>22</sup> Thereafter, it became common practice to record one's interest in the rents from encumbered property in the chattel mortgage index. The Iowa Supreme Court examined the need for this practice in *Equitable Life Insurance Co. v. Brown*.<sup>23</sup> The court stated:

Prior to the provision of our statute relating to the indexing of real estate mortgages embracing chattel mortgage clauses in the chattel mortgage index, which was enacted by the thirty-ninth General Assembly, chapter 246, and is now embraced in Code section 10032 of the 1931

17. IOWA CODE § 557.14 (1987).

18. *Id.*

19. In jurisdictions that follow a "title" theory based on the common law doctrine of mortgages, the mortgage is a conveyance of an estate by way of a pledge or security for the payment of a debt, or the performance of an obligation which would become void on the payment or performance. 59 C.J.S. Mortgages § 1 (1949). The conveyance passes the whole legal title to the mortgagee. *Id.*

20. In *Lower*, the Iowa Supreme Court stated: "we have long held the '[r]ecording is not a part of the execution, and an unrecorded instrument is valid as between the parties to it.'" *Federal Land Bank v. Lower*, 421 N.W.2d at 129 (quoting *State v. Eagle Petroleum Co.*, 261 Iowa 58, 68, 153 N.W.2d 115, 121 (1967)); see also *In re Estate of Lewis*, 230 Iowa 694, 700, 298 N.W. 842, 845 (1941); *Yetley v. Irons*, 238 Iowa 23, 26, 25 N.W.2d 677, 679 (1947).

21. 1921 Iowa Acts 246.

22. *Id.*

23. *Equitable Life Ins. Co. v. Brown*, 220 Iowa 585, 262 N.W. 124 (Iowa 1935).

Code of Iowa, the practice on the part of mortgagors in distress of leasing the premises and assigning the lease prior to the commencement of foreclosure proceedings became quite prevalent throughout the state, which called for the enactment of the statutory provisions above referred to, and it is now the settled rule in this state that the lien on the rents and profits created by the chattel mortgage clause in real estate mortgages, such as we have under consideration in the instant case, when held to be sufficient in form and substance, is effective from the date of the execution of the mortgage and not from the date of the filing of the petition of foreclosure in which the appointment of a receiver is asked, as formally.<sup>24</sup>

Later, the permissive indexing was made mandatory, giving Iowa a system by which mortgagees possessing an interest in the rents from encumbered property could record that interest in the local county recorder's chattel mortgage index.<sup>25</sup> This record served as constructive notice to all parties seeking to attach an interest to the encumbered property.

In 1965, the state of Iowa adopted the Uniform Commercial Code ("U.C.C.").<sup>26</sup> The provisions of Article 9 of the U.C.C. replaced the chattel mortgage index system. Secured interests are now perfected by the filing of a financing statement.<sup>27</sup> However, Article 9 specifically excludes "[t]he creation or transfer of an interest in or lien on real estate, including a lease or rents thereunder."<sup>28</sup> Therefore, since 1965, mortgagees have not had a defined method that placed third parties on notice of their liens on rents.

#### IV. HISTORY REPEATS ITSELF

The lack of a method to perfect interest in rents on encumbered property was not an issue in the late 1960s and 1970s. During this period, rising land prices caused landowner net worth to increase. A mortgage could be based in part on the increasing value of the underlying property.<sup>29</sup> As long

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24. *Id.* at 592, 262 N.W. at 127-28. *Brown* is also quoted in *In re Porter*, 90 Bankr. 399, 402 (Bankr. N.D. Iowa 1988). The holding in *Porter* is discussed later in the Article. See *infra* notes 43-57 and accompanying text.

25. 1927 Iowa Acts 212. Section 10032 of the code was amended, removing the words "if requested by the holder" which had the effect of making recordation mandatory. *Id.*

26. 1965 Iowa Acts 413. Iowa Code section 10032 was repealed by the language of Act 413, section 10103, which stated that all acts inconsistent with the adoption of the U.C.C. were repealed. *Id.*

27. IOWA CODE § 554.9302 (1987). Subsection 1 of the statute begins: "1. A financing statement must be filed to perfect all security interests. . . ." *Id.*

28. IOWA CODE § 554.9104(j) (1987). The statute provides: "This Article does not apply . . . j. except to the extent that provision is made for fixtures in section 554.9313, to the creation or transfer of an interest in or lien on real estate, including a lease or rents thereunder." *Id.*

29. Easterbrook, *supra* note 1, at 15. The author writes: "When briefly during the 1970s interest rates were below the inflation rate, borrowers came out ahead merely by borrowing." *Id.* "The economic conditions of the 1970s seemed to say that it had actually become smart to pile loans on top of loans. But if inflation stopped, the loans would smash into each other like

as this trend continued, the lender and borrower paid little attention to their rights in the event of default, and consequently, little attention was given to securing rights granted in the mortgage. When the downturn came, however,<sup>30</sup> both creditors and debtors became acutely aware that the money needed to service the debt was not there, and both sides began to assess their losses and assert their rights.

In *Brown*, the Iowa Supreme Court discussed the need to enforce an interest in rents from encumbered property.<sup>31</sup> What was true in the 1930s is still true today. In times of financial crisis, borrowers are less concerned with making mortgage payments and are more concerned with making an income. One ready source of income during a financial crisis is to lease the land to a third party. If the debtor's default becomes critical, leasing the land to a third party may be a final attempt to salvage something before the land is lost in foreclosure. This situation occurred in the 1930s, reoccurred in the 1980s, and could occur the next time there is a financial crisis in agriculture.

In times of an agricultural credit crisis, most legislative response is in the form of debtor relief. As an example, Iowa's mortgage foreclosure statute was supplemented during the 1930s to provide, among other things, continuances of uncompleted mortgage foreclosure proceedings and extensions of unexpired mortgage redemption periods.<sup>32</sup> In the 1980s, debtor relief statutes were rediscovered. These statutes were analyzed, applied, and amended in an attempt to lessen the harshness of mortgage foreclosure. For example, the Iowa Code now provides for a two-year continuance of foreclosure proceedings if the borrower's default is due to climatic conditions, or if the governor declares a state of economic emergency.<sup>33</sup> The debtor is also granted

race cars trying to avoid a wreck." *Id.*

30. See *supra* text accompanying note 1.

31. See *supra* text accompanying notes 23-24.

32. Bauer, *Judicial Foreclosure and Statutory Redemption: The Soundness of Iowa's Traditional Preference for Protection over Credit*, 71 IOWA L. REV. 1, 46 (1985).

33. IOWA CODE § 654.15 (1987). Subsections 1 and 2 of the statute provide:

1. In all actions for the foreclosure of real estate mortgages, deeds of trust of real property, and contracts for the purchase of real estate, when the owner enters an appearance and files an answer admitting some indebtedness and breach of the terms of the designated instrument, which admissions cannot be withdrawn or denied after a continuance is granted, the owner may apply for a continuance of the foreclosure action if the default or inability of the owner to pay or perform is mainly due or brought about by reason of drought, flood, heat, hail, storm, or other climatic conditions or by reason of the infestation of pests which affect the land in controversy.

2. In all actions for the foreclosure of real estate mortgages, deeds of trust of real estate, and contracts for the purchase of real estate, an owner of real estate may apply for a moratorium as provided in this subsection if the governor declares a state of economic emergency.

IOWA CODE § 654.15(1)-(2) (1987); see also 85 Iowa Acts 250 § 1-2; 86 Iowa Acts 1216 § 7-9.

notice of his right to cure his default,<sup>34</sup> and a separate right of redemption in his homestead following a foreclosure sale.<sup>35</sup> Additionally, if a receiver

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34. IOWA CODE § 654.2A (1987). Subsection 3 the statute provides:

3. The borrower has a right to cure the default unless the creditor has given the borrower a proper notice of right to cure with respect to two prior defaults on the obligation secured by the deed of trust or mortgage, or the borrower has voluntarily surrendered possession of the agricultural land and the creditor has accepted it in full satisfaction of any debt owing on the obligation in default. The borrower does not have a right to cure the default if the creditor has given the borrower a proper notice of right to cure with respect to a prior default within twelve months prior to the alleged default.

IOWA CODE § 654.2A(3) (1987); *see also* 86 Iowa Acts 1214 § 10.

35. IOWA CODE § 654.16 (1987). The statute provides:

If a foreclosure sale is ordered on agricultural land used for farming, as defined in section 175.2, the mortgagor may, by a date set by the court but not later than ten days before the sale, designate to the court the option of the land which the mortgagor claims as a homestead. The homestead may be any contiguous portion of forty acres or less of the real estate subject to the foreclosure. The homestead shall contain the residence of the mortgagor and shall be as compact as practicable. If the homestead is not sold separately, but rather is sold in conjunction with the nonhomestead property in order to satisfy the judgment, the court shall determine the fair market value of the homestead. The court may consult with the county appraisers appointed pursuant to section 450.24 to determine the fair market value of the homestead. The mortgagor may redeem the homestead separately by tendering the fair market value of the homestead pursuant to chapter 628.

IOWA CODE § 654.16 (1987); *see also* 86 Iowa Acts 1216 § 2.

On May 25, 1987, Iowa's General Assembly enacted legislation that amended or added to many of the mortgage foreclosure provisions of Iowa Code chapter 654. *See* 87 Iowa Acts 142 [hereinafter Act]. Most notably Iowa Code section 654.16 was amended by section 5 of the Act (codified at IOWA CODE § 654.16(5) (1989)) to provide mortgagors a new two-year right to redeem their homestead if the homestead had been purchased by a nonmember lending institution at a foreclosure sale. For the purposes of this statute, a lender was a "member" if the institution belonged to the F.D.I.C., F.S.L.I.C., or the N.C.U.A. *See* 87 Iowa Acts 142 § 5(5) (codified at IOWA CODE § 654.16(5) (1989)). Member institutions were subject to only a one-year period of redemption. More importantly, section 28 of the Act made the new redemption periods effective retroactively to one year before the effective date of the Act (June 4, 1987). As applied, this amendment gave a mortgagor whose homestead is purchased in a foreclosure sale either a one- or two-year statutory right of redemption, depending on the membership status of the purchaser. Furthermore, any mortgagor whose homestead had been purchased between June 4, 1986 and June 4, 1987 was also given this redemptive right. This amendment was immediately attacked by the Federal Land Bank on grounds that included a claimed violation of equal rights and due process under the United States Constitution and the Iowa Constitution as well as a claimed violation of the contracts clause of the United States Constitution. *See* Federal Land Bank v. Arnold, 426 N.W.2d 153 (Iowa 1988).

The Iowa Supreme Court found in favor of the Federal Land Bank, holding that the retroactive application of this amendment violated Article 1, section 10 of the United States Constitution (contracts clause). *Id.* at 161. The court also stated the member/nonmember classifications violated the equal rights clause of the United States Constitution and Iowa Constitution. *Id.* However, the court only invalidated the retroactive nature of the statute and the member/nonmember classifications; the new two-year redemption period remained. *Id.* Thus since *Arnold*, all lenders, regardless of their status, who purchase at a foreclosure sale are subject to a

takes possession of the property during the foreclosure process, the receiver shall give preference to the owner or person in actual possession.<sup>36</sup> Creditors are required to participate in mediation conferences and to receive a release from a mediator before they can commence with the foreclosure proceedings.<sup>37</sup>

In the 1930s the legislature provided some protection for creditors by enacting the chattel mortgage index system. When agriculture faced the credit crisis in the 1980s, however, the chattel mortgage index system had been abolished. As a result, there was no longer a specific statutory method for creditors to secure their interest, and the legislature did not respond to the creditors' needs as it responded to the needs of the debtors. The current judicial response is beginning to fill this void.

## V. THE CURRENT RESPONSE

The current response to the method of perfection begins with the Iowa Supreme Court's 1988 decision in *Federal Land Bank v. Lower*.<sup>38</sup> *Lower* stands for the principle that a receiver's right to the rents of mortgaged property granted in the mortgage is effective on the date the mortgage is executed, not the date the receiver is appointed.<sup>39</sup> The court did not decide how a lien on real estate rents could be perfected because the issue involved the validity of a mortgage between the mortgagee and mortgagor; a third party was not involved.<sup>40</sup>

mortgagor's right of redemption of the homestead for two years following a foreclosure sale that has occurred since June 4, 1987. One may conclude that while *Arnold* was a successful challenge to the constitutionality of debtor relief statutes, creditors may be reluctant to bring additional challenges for fear of prevailing in a similar fashion.

36. IOWA CODE § 654.14 (1987). The statute provides: "In an action to foreclose a real estate mortgage, if a receiver is appointed to take charge of the real estate, preference shall be given to the owner or person in actual possession, subject to approval of the court, in leasing the mortgages premises." IOWA CODE § 654.14 (1987); see also 86 Iowa Acts 1214 § 13.

Iowa Code section 654.14 has been interpreted strictly. The debtor must be offered a lease with terms equal to those offered to any other third party. If the debtor is able to meet the terms, preference must be given to the debtor. See *Federal Land Bank v. Heeren*, 398 N.W.2d 839 (Iowa 1987).

37. IOWA CODE § 654.2C (1987). The statute provides:

A person shall not initiate a proceeding under this chapter to foreclose a deed of trust or mortgage on agricultural property, as defined in section 654A.1, which is subject to chapter 654A and which is subject to a debt of twenty thousand dollars or more under the deed of trust or mortgage unless the person receives a mediation release under section 654A.11, or unless the court determines after notice and a hearing that the time delay required for the mediation would cause the person to suffer irreparable harm.

IOWA CODE § 654.2C (1987); see also 86 Iowa Acts 1214 § 12.

38. *Federal Land Bank v. Lower*, 421 N.W.2d 126 (Iowa 1988).

39. *Id.* at 129.

40. *Id.* The court stated, "[i]n the present case, we are deciding the validity of an instrument as between the parties to it, without any third party being involved." *Id.*

Since *Lower*, two other Iowa cases have dealt directly with the question of perfection of an interest in rents granted in a mortgage secured by agricultural land.<sup>41</sup> The facts in both cases satisfied the necessary elements of (1) a grant of an interest in the rents in the mortgage, and (2) the involvement of a third party. Both cases resulted in similar outcomes.

The first case, *In re Porter*,<sup>42</sup> was a bankruptcy proceeding in which the Federal Land Bank ("Land Bank") asserted its rights to the rents received by the debtor.<sup>43</sup> The debtor, Porter, received a loan for which a promissory note and a mortgage encumbering her farm were executed in favor of the Land Bank.<sup>44</sup> "The granting clause in [the] mortgage not only mortgaged and conveyed the real estate, but also mortgaged and conveyed 'all the right, title and interest (now owned or hereafter acquired) . . . in said property . . . and the rents, issues, crops and profits arising from said lands.'"<sup>45</sup> Porter leased the farm to a third party, and received rental payments before filing a petition in bankruptcy.<sup>46</sup> Because the Land Bank had not filed a foreclosure proceeding, or applied for the appointment of a receiver, the bankruptcy court determined the debtor, or in this case the trustee, held the rents free and clear of the lien held by the Land Bank.<sup>47</sup>

The bankruptcy court relied on *In re Winzenburg*,<sup>48</sup> which reached the same conclusion. However, the mortgage in *Winzenburg* contained a pledge of rents and profits that served only as secondary security and required the appointment of a receiver.<sup>49</sup> On appeal, the United States District Court for the Northern District of Iowa reversed, holding that because the Land Bank's mortgage contained a grant of rents and profits, the Land Bank had "a valid present lien on the rent money the debtor received prior to the time of filing for bankruptcy."<sup>50</sup> More importantly, because the Land Bank recorded the mortgage at the county recorder's office, the court held the Land Bank's position was perfected and superior to that of the trustee.<sup>51</sup>

In reaching this decision the court noted that the Iowa Supreme Court, in *Lower*, stated: "To begin, Iowa Code section 554.9104(j) (1985) says very

41. See *In re Porter*, 90 Bankr. 399 (Bankr. N.D. Iowa 1988); *Federal Land Bank v. Dunkelberger*, No. 31536 (Boone County, Iowa, Dist. Ct. July 19, 1988).

42. *In re Porter*, 90 Bankr. 399 (Bankr. N.D. Iowa 1988).

43. *Id.*, *In re Porter* was originally filed as *Federal Land Bank v. Terpstra*, No. C87-0063. The decision was handed down on May 26, 1988.

44. *Id.* at 400.

45. *Id.* (emphasis added).

46. *Id.*

47. *Id.*

48. *In re Winzenburg*, 61 Bankr. 141 (Bankr. N.D. Iowa 1986).

49. *In re Porter*, 90 Bankr. at 400; see *supra* text accompanying notes 10-14, which discusses the current distinction between primary and secondary security.

50. *In re Porter*, 90 Bankr. at 401. The *Lower* court also found *Winzenburg* to be inapplicable in the situation in which the mortgage granted an interest in the rents with the conveyance of the land. *Federal Land Bank v. Lower*, 421 N.W.2d at 129.

51. *In re Porter*, 90 Bankr. at 404.

plainly that the secured transaction article of the U.C.C. does not apply 'to the creation . . . of . . . [a] lien on real estate, including . . . rents thereunder.'<sup>52</sup> Therefore, the court sought another statutory basis for perfection of a lien on rents.

The court found a basis in chapter 558 of the Iowa Code. The court stated, "Iowa Code section 558.1 defines instruments affecting real estate as 'all instruments . . . in any manner relating to real estate.'<sup>53</sup> Using this provision the court went on to hold that "a present day grant of a security interest in future rents in particularly described real property is entitled to recording under Iowa Code section 558.1 as an instrument 'relating to real estate.'<sup>54</sup>

Section 558.41 provides: "No instrument affecting real estate is of any validity against subsequent purchasers for a valuable consideration, without notice, unless filed in the office of the recorder of the county in which the same lies, as hereinafter provided."<sup>55</sup>

The court approved of the Land Bank's recording the mortgage in the county recorder's office as the acceptable method of perfection of an interest in rents. The court stated, "The filing and recording of the Land Bank's mortgage . . . did the same thing, i.e., the imparting of notice to the whole world, that recording and indexing of a chattel mortgage index did prior to 1965 under the *Brown* line of cases."<sup>56</sup> Recording the mortgage in the county recorder's office "results in the same type of notice that perfection under the U.C.C. gives to personal property security interests—that is, notice to the world of the existence of the lien."<sup>57</sup>

The second case addressing the issue of perfection of an interest in rents was *Federal Land Bank v. Dunkelberger*.<sup>58</sup> The Iowa District Court for Boone County applied the same code provisions as the court in *Porter* applied in reaching its decision. In *Dunkelberger*, the Land Bank instituted proceedings to foreclose a mortgage in which the granting clause conveyed to Land Bank "all of the right, title, and interest of the mortgagors in said property now owned, or hereinafter acquired . . . including also all the rents, issues, uses, profits, and income from such real estate."<sup>59</sup> The mortgage, executed by the Dunkelbergers and the Land Bank, was recorded in the recorder's office.<sup>60</sup> In *Dunkelberger* the third party was a lessee renting

52. *Id.* at 402 (emphasis added); see *supra* note 27.

53. *Id. re Porter*, 90 Bankr. at 403 (quoting IOWA CODE § 558.41 (1987)).

54. *Id.* at 404.

55. IOWA CODE § 558.41 (1987). Iowa Code section 558.41 is commonly referred to as Iowa's recording statute.

56. *In re Porter*, 90 Bankr. at 404.

57. *Id.*

58. *Federal Land Bank v. Dunkelberger*, No. 31536 (Boone County, Iowa, Dist. Ct. July 19, 1988).

59. *Id.* at 1-2 (emphasis added).

60. *Id.*

the Dunkelbergers' property under a ten-year lease signed prior to the Land Bank's foreclosure proceeding.<sup>61</sup> Applying the reasoning of *Lower*, the court held the Land Bank had a perfected interest in the rents that the Dunkelbergers had and would receive from the third-party lessee.<sup>62</sup> In a result similar to *Porter*, the court held that recording the mortgage, which contained a grant of an interest in the rents from the encumbered property, created a secured position and served as constructive notice to all others.<sup>63</sup> Chapter 558 of the Iowa Code again served as the statutory basis for the recording of a security interest in future rents.<sup>64</sup>

In *Dunkelberger* the court determined the lessee had notice of the lien on the rents from an additional source. Because the lease was not entered into until after the foreclosure proceedings had begun, the filing of a foreclosure petition with the county clerk also served as constructive notice of a lien to a third party.<sup>65</sup> Pursuant to Iowa Code section 617.11, "no interest can be acquired by third persons in the subject matter thereof as against the plaintiff's rights."<sup>66</sup> Therefore, the court ordered the third-party lessee to make rental payments, including rental payments from previous years, to the receiver in the Land Bank's foreclosure proceeding.<sup>67</sup>

The holding in *Dunkelberger* may alarm third-party lessees who fear being required to pay rent twice; once to the lessor and again to the receiver. This concern is well founded if third-party lessees rent from a landlord involved in a foreclosure proceeding. Double payment of rent, however, was not the result in *Dunkelberger*. The lessor and lessee entered the ten-year lease with the understanding that the lessee would deduct the annual rental payment from an amount the lessor owed to him for custom farming services performed in the past.<sup>68</sup> Under this agreement, a rental payment was not actually made. Therefore, the court ordered the third-party lessee to pay the receiver the rental payments. It can be inferred that this order did not affect the account that the lessee had with the lessor and he still could seek payment in full for his past custom farming services.<sup>69</sup>

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61. *Id.*

62. *Id.* at 12-13.

63. *Id.* at 7. The court refers to *Porter* as *In re Terpstra* because this was the caption of the original filing. See *supra* note 43.

64. Federal Land Bank v. Dunkelberger, No. 31536, at 6 (Boone County, Iowa, Dist. Ct. July 19, 1988).

65. *Id.* at 8.

66. IOWA CODE § 617.11 (1987). The statute provides: "When so indexed, said action shall be considered pending so as to charge all third persons with notice of its pendency, and while pending no interest can be acquired by third persons in the subject matter thereof as against the plaintiff's rights." *Id.*

67. Federal Land Bank v. Dunkelberger, No. 31536, at 14 (Boone County, Iowa, Dist. Ct. July 19, 1988).

68. *Id.* at 2.

69. *Id.* at 14. The order also included a modification of the rental amount. The rent was raised from \$75.00 to \$85.00 per acre. The lessor was ordered to pay this \$10.00 differential to

## VI. OTHER APPLICATIONS OF LOWER

Other interpretations of *Lower* have also resulted in similar applications. As noted earlier, the basis for the decisions in *Porter* and *Dunkelberger* was found in Iowa Code section 554.9104(j), which explicitly excludes "[t]he creation or transfer of an interest in or lien on real estate, including a lease or rents thereunder."<sup>70</sup> Therefore, the method of perfecting an interest in the rents and profits is not controlled by the U.C.C. Rather, the courts look to see if a mortgage containing a grant of rents had been filed in the appropriate county recorder's office.

Following the *Porter* and *Dunkelberger* decisions, the United States Bankruptcy Court for the Northern District of Iowa addressed the issue of whether the method of perfection adopted by the court in *Porter* applied to a security interest in growing crops.<sup>71</sup> In *In re Waters*,<sup>72</sup> the Production Credit Association ("PCA") entered into a lender-borrower relationship with the Waters brothers, acting as the primary operational lender for the Waters' farming operation.<sup>73</sup> The language of the mortgage contained a grant of rents and profits.<sup>74</sup> The PCA filed for foreclosure and requested the appointment of a receiver.<sup>75</sup> The Association contended the crops being raised on the encumbered property were subject to the grant of rents and profits in the real estate mortgage.<sup>76</sup> Therefore, the PCA took the position that because the mortgage was recorded and a receiver requested, its interest in the growing crops had been perfected.<sup>77</sup>

In this situation, growing crops are included within the provisions of the U.C.C.<sup>78</sup> Therefore, the court noted that any interest in the growing crops must be perfected according to the relevant provisions of the U.C.C.<sup>79</sup> The court found support for its decision in the language of *Porter* and *Lower*.

the receiver *subject* to any payments made by the lessee.

70. IOWA CODE § 554.9104(j) (1987); *In re Porter*, 90 Bankr. 399, 402 (Bankr. N.D. Iowa 9188); *Federal Land Bank v. Dunkelberger*, No. 31536, at 6.

71. *In re Waters*, 90 Bankr. 946 (Bankr. N.D. Iowa 1988).

72. *Id.*

73. *Id.* at 951-52.

74. *Id.* at 966.

75. *Id.*

76. *Id.*

77. *Id.*

78. IOWA CODE § 554.9109 (1987). The statute provides:

Goods are

. . . .

(3). "farm products" if they are crops or livestock or supplies used or produced in farming operations, or if they are products of crops or livestock in their unmanufactured states (such as ginned cotton, wool clip, maple syrup, milk, eggs), and if they are in the possession of a debtor engaged in raising, fattening, grazing or other farming operations. If goods are farm products they are neither equipment nor inventory.

IOWA CODE § 554.9109 (1987).

79. *In re Waters*, 90 Bankr. at 967.

The court quoted language from *Porter*:

[T]he decision [*In re Porter*] is limited by and to the particular facts of this case. Because the U.C.C. has very carefully crafted provisions concerning the granting and perfecting of security interests in all other items of personal property (see sec. 554.9102 for the broad scope of Article 9), including crops (which provisions are not implicated by the holding in this case), this decision is of necessity quite narrow in its reach.<sup>80</sup>

The *Waters* court also stated, "The *Lower* decision was very specific in pointing out that the grant of a security interest in cash rents was specifically excluded from coverage under the U.C.C. Clearly, the grant of a security interest and perfection of that interest in crops is covered by the U.C.C."<sup>81</sup>

Thus, *Waters* draws a definite line identifying when the current response should apply to conflicting claims arising when a third party is given an interest in the mortgaged property. According to *Waters*, the current response does not apply to the method of perfection for items of personal property falling within the broad scope of Article 9.

While *Waters* limited the applicability of the current response, *In re Hollinrake*<sup>82</sup> expanded it. The court in *Hollinrake* suggested the current response of perfection of a security interest applied to commercial interests in land, in addition to interests in agricultural land. The dispute in *Hollinrake* began with a fact pattern similar to the cases discussed above. As evidence of a loan, the Land Bank received a note from the Hollinrakes that was secured by a first mortgage on the Hollinrake farm.<sup>83</sup> The mortgage contained a granting clause that pledged the rents from the mortgaged property.<sup>84</sup> The clause also granted the Land Bank an interest in the proceeds of the mineral rights of the property.<sup>85</sup> The Land Bank filed this mortgage at the county recorder's office.<sup>86</sup> Later, the Hollinrakes entered into a lease, granting a coal company the right to mine the coal and other minerals on the farm.<sup>87</sup> The Hollinrakes then assigned all proceeds, rents, and royalties due under the mineral lease to a second mortgagee, Peoples National Bank and Trust ("Peoples").<sup>88</sup> This assignment was also recorded at the county recorder's office.<sup>89</sup> When the Hollinrakes defaulted on the mortgage pay-

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80. *Id.* (quoting *In re Porter*, 90 Bankr. at 404).

81. *Id.*

82. *In re Hollinrake*, 93 Bankr. 183 (Bankr. S.D. Iowa 1988).

83. *Id.* at 185.

84. *Id.*

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.*

ments, the Land Bank filed foreclosure proceedings.<sup>90</sup> Peoples failure to pay<sup>91</sup> caused its interest in the lease of the mineral rights to be transferred to First National Bank ("First National").<sup>92</sup> In the dispute over the rental payments due under the lease, the court was presented with more than a question about the method of perfection. In this situation both parties, the Land Bank and First National, had interests perfected by recording the mortgage with the county recorder's office. The ultimate issue was which interest had priority.

First National asserted that the Land Bank's interest in the mineral royalties did not attach until foreclosure proceedings had begun.<sup>93</sup> Because this occurred after the Hollinrakes assigned their interests in the rents and profits to Peoples, which was the interest First National acquired, First National claimed a position of priority.<sup>94</sup>

The court resolved the issue in favor of the Land Bank. Arriving at its decision, the court cited *Lower* for the principle "that a conveyance of rents along with land in the granting clause created a lien on rents upon execution of the mortgage."<sup>95</sup> Therefore, because the mortgage entered into by the Land Bank and the Hollinrakes contained a grant of an interest in the rents and profits from the Hollinrake farm, the interest was capable of perfection at the time the mortgage was executed. When the Land Bank recorded the mortgage, priority was established over filings of later interests in the land.

The court's analysis applied a first in time—first in right rule<sup>96</sup> to settle the dispute concerning rents and profits from the land. This rule applies,

90. *Id.* at 186.

91. The agricultural credit crisis had disastrous effects on farmers, their lenders, and entire rural economies. See generally Lasley, *The Crisis in Iowa*, in IS THERE A MORAL OBLIGATION TO SAVE THE FAMILY FARM? 107 (G. Comstock ed. 1987). The author writes:

As farmers have made financial adjustments and reduced their expenditures for inputs, local main-street businesses and agribusinesses have been adversely affected. The data suggest that farmers are concerned about their own families' quality of life and financial conditions as well as the future of family farming and rural community viability.

*Id.*

92. *In re Hollinrake*, 93 Bankr. at 185-86.

93. *Id.* at 186.

94. *Id.*

95. *Id.*

96. *Id.* at 189. The court stated:

First national makes no claim that either People's or it was without notice of the FLB lien via the mortgage that had been filed with the Monroe County Recorder on January 17, 1975. Thus, under a *Terpstra* [*Porter*] common sense approach, the FLB's interest in rents should take priority over that of First National.

*Id.*

The United States District Court for the Southern District of Iowa adopted the perfection method that was applied by the Northern District of Iowa in *Porter*. *Id.* Thus, both districts of the federal courts in Iowa will follow an analysis that allows perfection by recordation of an interest in rents granted in a mortgage.

however, only if each creditor properly perfects its interest in the method provided by the cases interpreting the *Lower* decision.

## VII. ANALYSIS

The preceding cases clarify that an interest in the rents from encumbered land is an interest capable of perfection. The interest exists if it is granted in a mortgage executed by the parties. When the mortgage is recorded at the office of the county recorder, the rest of the world is put on notice.

Although these cases have ended some of the speculation, they may have little effect on the required actions of creditors. This conclusion is drawn from the language of chapter 558 of the Iowa Code. Section 558.41 makes recording mandatory if an "instrument affecting real estate" is to have validity.<sup>97</sup> Thus, if a mortgage grants an interest in the future rents, compliance with mandatory recording of mortgages will "automatically" perfect the mortgagee's interest in the rents from the secured property. As a result, all mortgagees should make sure the following occur: (1) the mortgage language contains a grant of a lien on the rents; and (2) there is compliance with Iowa Code section 558.41.

The mortgagee should pay careful attention to the language of the mortgage, keeping in mind the distinctions between a grant that creates primary security and a pledge that serves only as secondary security.<sup>98</sup> On the other hand, the mortgagor should be aware that a lien on rents is effective when the mortgage is executed and is perfected when the mortgage is recorded. Mortgagors should consider their liability under the mortgage when they are contemplating leasing encumbered property to a third party.

Finally, the third party should be considered. Under the holding of *Lower*, a grant in future rents in the mortgage is effective from the date of execution,<sup>99</sup> and the rent that would be paid by a lessee to a mortgagor/landlord is secured by the mortgagee when the mortgage is recorded. Thus, a tenant should be aware of a possible "double-hit" for rent if his landlord's mortgage contains a grant of rents.

## VIII. PROPOSAL FOR A LEGISLATIVE RESPONSE

It is important to note *Dunkelberger* is an unpublished state court decision,<sup>100</sup> but *Porter, Waters*, and *Hollinrake* are decisions from United States district courts.<sup>101</sup> The Iowa Supreme Court may be influenced by the lan-

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97. IOWA CODE § 558.41 (1987).

98. See *supra* text accompanying notes 10-14.

99. *Federal Land Bank v. Lower*, 421 N.W.2d at 129.

100. See *supra* note 55.

101. See *supra* notes 40, 68, 77. The *Porter* and *Waters* decisions come from the Northern District of Iowa and *Hollinrake* is an opinion from the Southern District.

guage of these cases, or the court may devise a different result when deciding the rule in Iowa. Rather than waiting for additional litigation concerning this matter, a statute may be in order. A statute providing a method of perfection would add certainty to the relationship between debtors and creditors.

The legislature could adopt a statute to effect the same result as the courts did in the cases discussed above. The result could be reached by amending chapter 558 to recognize a lien on rents as an interest that can be recorded. The *Porter* court opined that the recording of a mortgage granting a lien on future rents would fill the void left from the chattel mortgage index system and would be analogous to a U.C.C. filing for personal property security interests.<sup>102</sup>

However, an amendment of this nature may be too simplistic. While an "automatic" method of perfection secures the mortgagee's interest and serves as constructive notice, it ignores the third-party lessee. Giving a mortgagor a secured interest in future rents without qualifying when the interest can be enforced results in a third party being uncertain as to whom to pay rent. A lessee would continue to be caught in the middle of disputes over the right to rental payments, and the courts would continue to be called on to settle the disputes. Even if a lessee has actual notice of a mortgagee's perfected interest, he can never be sure when the mortgagee will step in, claiming a secured right.

Proposed legislation should seek to add certainty, not only for the mortgagor and the mortgagee, but also for the third-party lessee. As noted earlier, when the rents are pledged as security, the mortgagee does not have a right to the rents until default.<sup>103</sup> Using this principle, a more comprehensive statute would provide that the mortgagee's interest is perfected when the mortgage is recorded under chapter 558, and that the right is waived until default occurs.<sup>104</sup> Such an approach would still secure the mortgagee's rights to the future rents at execution. A waiver limitation would not diminish the mortgagee's rights. The mortgagee should be concerned with enforcing a lien on the rents only when the mortgage payments are not being made.

Such a statutory provision would not conflict with the priority resolution reached by the *Hollinrake* court.<sup>105</sup> The first in time—first in right rule will apply when the dispute is between multiple creditors seeking the rental

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102. *In re Porter*, 90 Bankr. 399, 404 (Bankr. N.D. Iowa 1988); see also *supra* text accompanying note 54.

103. See *supra* text accompanying note 11.

104. See *Federal Land Bank v. Dunkelberger*, No. 31536 (Boone County, Iowa, Dist. Ct. July 19, 1988). The defendants in *Dunkelberger* raised the defense of waiver. *Id.* at 12. The court responded that even though the Land Bank had waived its security interest in the rents and profits for twenty years, the waiver ended when the mortgage foreclosure proceeding was filed. *Id.*

105. See *supra* text accompanying note 91.

payments. A perfection/waiver statute will apply only when a third-party lessee, who does not have a creditor's interest in the land, is involved. A statute of this type would help the lessee determine to whom the rental payments should be made.

It may be necessary to include a requirement that the mortgagee provide notice of default to a third-party lessee as well as the mortgagor when the mortgagor is in default. This is a valid provision considering a recent Iowa Supreme Court case that held a tenant, as a person in possession, should receive notice of the forfeiture of an installment land contract when the purchaser defaults.<sup>106</sup> Including this requirement in a statute, which provides a method of perfection/waiver of an interest in future rents from mortgaged property, provides a clearer definition of rights for the third parties to a mortgage, those affected by the mortgage, and their representatives.

### IX. CONCLUSION

*Lower* and later cases added to the analytical framework to determine when the status of the parties in a dispute over the rents and profits from encumbered property must be made. If the dispute is between the mortgagee and mortgagor, the contractual language of the mortgage can be applied.<sup>107</sup>

Competing creditors need to perfect their respective interests in land by recording their interest with the county recorder's office, or by filing a financing statement with the secretary of state to secure an interest in personalty covered by Article 9. Priority can then be determined by the first in time—first in right rule.<sup>108</sup>

When a third party is involved, a different process is used to determine whether the mortgagee has a right to the rents and profits from the encumbered property. The current response provides a mortgagee, who records a granted interest in the rents, has an interest that is perfected at the time of execution. This interest is "good against the whole world,"<sup>109</sup> including later lessees, assignees, or trustees. It remains to be seen, however, whether the current response will be followed.

A statute providing for a method of perfection to fill the void left from the chattel mortgage index system may be preferable. In that way, the next time there is a financial crisis in agriculture, the parties to a mortgage will know what their rights are and will not have to rely on the courts to make the "line in the dirt" clearer.

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106. See *Jamison v. Knosby*, 423 N.W.2d 2 (Iowa 1988).

107. See *supra* note 19.

108. See *supra* text accompanying note 91.

109. See *supra* text accompanying notes 53-54.