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**Nebraska's Adoption of Statutory Provisions for
the Creation, Perfection and Enforcement of
a Security Interest in Real Estate Rents**

by

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NEBRASKA'S ADOPTION OF STATUTORY PROVISIONS FOR THE CREATION, PERFECTION AND ENFORCEMENT OF A SECURITY INTEREST IN REAL ESTATE RENTS

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INTRODUCTION

The rental payments generated from a commercial real estate project, such as a shopping center or an apartment complex, are often the primary source of repayment of a debt secured by the real estate. Although rent payments would appear to be personal property and otherwise subject to the provisions of Article 9 of the Uniform Commercial Code, an interest in a lease of real property and rent payments are excluded from the scope of Article 9.¹ Accordingly, lenders must look to real property law to determine issues such as creation, priority, and enforcement of an interest in real estate leases and the rents derived therefrom.

In order to include rents as part of the collateral for a loan secured by real estate, lenders have inserted "rents, issues, and profits" clauses in real estate mortgages or trust deeds, or have obtained a separate assignment of rents. Although the lender may have included a rents clause in the mortgage or obtained a separate assignment, under applicable law, the lender could experience significant delay, expense, and uncertainty in the enforcement of a rents provision. Legislative Bill 14 ("L.B. 14"), recently enacted by the Nebraska Unicameral, is a significant step in eliminating the delay, expense, and uncertainty in the creation and enforcement of a security interest in rents. This Article will review the historical development of Nebraska law concerning the creation and enforcement of a collateral interest in rents. This Article will then discuss both the substantive and procedural elements of L.B. 14.

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1. See U.C.C. § 9-104(j) (Rev. ed. 1958) which generally provides that Article 9 does not apply to "the creation or transfer of an interest in or lien on real estate, including a lease or rents thereunder." *Id.* See also, Metropolitan Life Ins. Co. v. Reeves-Gustafson, 228 Neb. 233, 422 N.W.2d 72 (1988).

THE DEVELOPMENT OF THE LAW CONCERNING THE
CREATION AND ENFORCEMENT OF A COLLATERAL
INTEREST IN RENTS: A HISTORICAL PERSPECTIVE

A. ENGLISH COMMON LAW

The claim of a mortgagee to rents and profits from mortgaged real estate has been a matter of contention for hundreds of years. The issue can be traced back to an early form of real estate security, the common-law gage of England. The English gages consisted of two primary types, "the vif gage or vivum vadium ('living pledge') and the mort gage or mortuum vadium ('dead pledge')."²

Either type of gage permitted the gagee to take possession of the encumbered land and to collect the rents and profits therefrom.³ A vif gage required that the gagee use the rents and profits collected from the encumbered land to reduce the outstanding debt, while the mort gage carried no such requirement.⁴ No matter which gage was employed to utilize the land and rents as security for a debt, possession was the "primary means by which a gagee was able to manifest his interest in the property."⁵ The gage instrument could include a forfeiture clause, providing that the lender would *acquire title* to the real estate if the debtor defaulted in the repayment of the debt.⁶

B. THE NEBRASKA RULES ON THE CREATION AND ENFORCEMENT OF
AN INTEREST IN RENTS

During the development of American mortgage law, the English common-law doctrines were replaced with the concept of a lien on the mortgaged land as security for the debt.⁷ Generally, the mortgagor retained title, possession, and correspondingly the right to the rents.⁸

If a lender wanted to obtain a collateral interest in a lease and the rental payments, the lender needed to consider several items in terms

2. Ann M. Burkhardt, *Freeing Mortgages of Merger*, 40 VAND. L. REV. 283, 305 (1987) (citing J. STORY, COMMENTARIES ON EQUITY JURISPRUDENCE § 1348 (14th ed. 1918)).

3. Burkhardt, 40 VAND. L. REV. at 305 (citing R. GLANVILLE, A TREATISE ON THE LAWS AND CUSTOMS OF THE KINGDOM OF ENGLAND, bk. X, ch. 6-11 (J. Beames trans., 1900)).

4. Burkhardt, 40 VAND. L. REV. at 306.

5. *Id.* at 308.

6. *Id.*

7. *Id.* at 326. The discussion of creation and enforcement of an interest in rents is presented in the context outside of a bankruptcy case. For a discussion of the issues related to a claim to rents in the context of a bankruptcy case, see John C. Minahan, Jr., *Rents and Profits In Bankruptcy, a Nebraska Primer and Consideration of L.B. 14*, 27 CREIGHTON L. REV. 158 (1993).

8. *Federal Farm Mortgage Corp. v. Ganser*, 146 Neb. 635, 20 N.W.2d 689 (1945); see *Kooistra v. Gibford*, 207 N.W. 399 (Iowa 1926).

of the creation and enforcement of an interest in rents. Those issues would include: (1) whether it was necessary that the mortgage contain a specific grant of an interest in rents; (2) when and how an interest in rents was perfected; (3) whether the interest granted was an "equitable lien" or a contractual interest; (4) how to enforce an interest in rents; (5) the relative priority between competing lenders; and (6) the status of an interest in rents in the event of a bankruptcy by the mortgagor.

The general rule that developed was that the mortgagor could grant to the mortgagee an interest in rents. However, in order to enforce an interest in rents the mortgagee was required to gain "possession" or "control" of the real estate in order to collect on the rents.⁹ Possession or control would normally require the commencement of judicial proceedings in order to obtain the appointment of a receiver or grant the mortgagee the status of a mortgagee-in-possession. The requirement of "possession" or "control" seems to have been derived from the concept that rents are derived from, or are inherently "attached" to, the real estate, and the party-in-possession has the superior entitlement to any rental payments.

Under Nebraska case law consistent with the general rule described above, the mortgagor retained the right to collect rents derived from the real estate. The mortgagor could grant to the mortgagee a collateral interest in rents, and upon default by the mortgagor, the mortgagee could seek to enforce its claim to rents.¹⁰ An early statement of the law in Nebraska regarding the rights of the parties to rents can be found in an 1879 opinion of the Nebraska Supreme Court:

In an absence of an agreement to the contrary, we suppose no one would contend but that a mortgagor is entitled to the rents and profits of mortgaged premises until condition broken; or, in other words, *until such time as the mortgagee is authorized to proceed by action on the mortgage to subject the property to the payment of his debt*. Such, doubtless, is the law. On the other hand it is equally clear that on a condition broken, by which the mortgagee is authorized to commence foreclosure proceedings if the property be inadequate secur-

9. Many states required that the mortgagee take possessory action, such as seeking the appointment of a receiver, even if the rents and profits were specifically pledged. However, some states recognized the validity and enforceability of the specific assignment with no requirement for the mortgagee to show equitable necessity, such as waste, to justify the appointment of a receiver. (*E.g.*, *Chicago Title & Trust Co. v. Fox Theatres Corp.*, 14 F. Supp. 686 (S.D.N.Y. 1936) (giving effect to an assignment to a trustee)).

10. The use of the term "mortgagee" is not intended as a limiting concept. A trust deed could also include a rents clause wherein the trustor would grant an interest in rents to the trustee for the benefit of the beneficiary. The term "mortgagee" or "mortgagor" as used in this article can be read interchangeably with the terms "trustor" or "trustee-beneficiary."

ity, he has thenceforward an equitable lien upon the rents and profits, or so much thereof as may be necessary to the security of the mortgage debt, *which he may enforce by proper proceedings*.¹¹

In general, Nebraska law provides that: (1) the mortgagor may grant a collateral interest in rents; (2) the mortgagor retains the "right" to collect rents until default, notwithstanding any pledge of rents in the mortgage; (3) the mortgagee may seek judicial enforcement of its collateral interest in rents upon default; and (4) generally, the form of judicial enforcement is the request for the appointment of a receiver in the context of a foreclosure proceeding.¹² The enforcement of the collateral interest in rents is limited in two areas. First, it appears that an event of default must occur prior to the mortgagee seeking enforcement of its claim to rents.¹³ Second, the enforcement of an interest in rents is not self-effectuating and requires either judicial enforcement through the appointment of a receiver or the mortgagee becoming a mortgagee-in-possession.¹⁴

The appointment of a receiver is generally governed by statute.¹⁵ In Nebraska the receivership statute authorizes the appointment of a receiver in a foreclosure proceeding if the mortgaged property is "in danger of being lost, removed, or materially injured or is probably insufficient to discharge the mortgage debt."¹⁶ Unless the mortgagee

11. *Jacobs v. Gibson*, 9 Neb. 380, 2 N.W. 893, 894 (1879) (emphasis added). See *Federal Land Bank of Omaha v. Victor*, 232 Neb. 351, 440 N.W.2d 667 (1989); *Waldron v. First Nat'l Bank of Greenwood*, 60 Neb. 245, 82 N.W. 856 (1900); *Philadelphia Mortgage & Trust Co. v. Goos*, 47 Neb. 804, 66 N.W. 843 (1896). Nebraska law also recognized an equitable lien in rents even in the absence of a specific grant of an interest in rents in the mortgage. See *Ganser*, 146 Neb. at 635, 20 N.W.2d at 689.

12. See *Saline State Bank v. Mahloch*, 834 F.2d 690 (8th Cir. 1987); *First Federal Sav. & Loan v. Cal-Neb. Land Co.*, 219 Neb. 887, 367 N.W.2d 136 (1985); *Central Savings Bank v. First Cadco Corp.*, 186 Neb. 112, 181 N.W.2d 261 (1970); *Fred V. Gentsch, Inc. v. Burnett*, 173 Neb. 820, 115 N.W.2d 446 (1962). A mortgage requires judicial proceedings in order to realize upon the real estate collateral. However, under a trust deed, the enforcement proceedings are nonjudicial. Under a trust deed after appropriate notice is provided to the trustor, the trustee sells the real estate at public sale. Accordingly, a beneficiary under a trust deed who seeks to collect rents during the notice period prior to sale would have to institute a separate proceeding seeking the appointment of a receiver to collect rents.

13. *Mahloch*, 834 F.2d at 694; see *In re Anderson*, 50 B.R. 728, (Bankr. D. Neb. 1985). The concept of requiring an event of default prior to enforcement of an interest in rents is consistent with the general proposition that the mortgagee could not seek to foreclose on the real estate in the absence of an event of default. However, in the context of the U.C.C., a secured party with an interest in accounts could collect accounts prior to an event of default if permitted under the terms of the security agreement. See U.C.C. § 9-502 (Rev. ed. 1958).

14. *Hanks v. Northwestern State Bank of Hay Springs*, 143 Neb. 204, 9 N.W.2d 175. *Contra* U.C.C. § 9-502 wherein collection of accounts is self-effectuating and generally does not require judicial proceedings.

15. NEB. REV. STAT. § 25-1081 (1992).

16. *Id.*

can establish a statutory basis for the appointment of a receiver, the mortgagee may not be able to recover the rents even though the mortgage grants an interest in rents.¹⁷

Accordingly, the general Nebraska rule is that a mortgagor may grant to the mortgagee an interest in rents. Upon the occurrence of an event of default under the mortgage, the mortgagee can assert its claim to rents through judicial proceedings by either obtaining the appointment of a receiver or becoming a mortgagee-in-possession. However, if the mortgagee can not establish the requirements for a receiver, then the mortgagor would retain possession and control of the real estate and any rents generated by the real estate.

L.B. 14

The foregoing discussion is now only of historical interest. Legislative Bill 14 ("L.B. 14") views leases and rents payable under a lease as a contract subject to assignment by the mortgagor and provides a structured and predictable system for obtaining and enforcing a security interest in rents and eliminates the uncertainties and difficulties of the prior law.¹⁸

17. See *Federal Land Bank of Omaha v. Victor*, 232 Neb. 351, 440 N.W.2d 667 (1989).

18. L.B. 14, Neb. Unicameral, 93d Leg., 1st Sess., 1993 Neb. Laws 57 [hereinafter L.B. 14]. L.B. 14 provides in relevant part:

Section 1. for purposes of sections 1 to 8 of this act:

(1) Assignee shall mean the holder, and his or her successors and assigns, of a security interest in rents which has been created, provided, assigned, or granted by an assignor;

(2) Assignment instrument shall mean any mortgage, trust deed, assignment of leases, assignment of rents, or other instrument or agreement which creates, provides, assigns, or grants a security interest in rents;

(3) Assignor shall mean a person, and his or her successors and assigns, who has created, provided, assigned, or granted a security interest in rents to an assignee;

(4) Lease shall mean any license, lease, contract, or other agreement for the use or possession or [sic] real estate;

(5) Rent party shall mean the party that is obligated under a lease to pay rents;

(6) Rents shall mean any right to income, rents, proceeds, issues, profits, royalties, or any other payment or benefit derived under a present or future lease; and

(7) Security interest in rents shall mean any interest in rents or leases which secures payment or performance of an obligation.

Sec. 2. An assignment instrument may provide that any or all obligations covered by, described in, or identified by the assignment instrument are to be secured by present, future, or after-arising rents or leases. The obligations covered by, described in, or identified by an assignment instrument may include future advances or other value whether or not the future advances or value are given pursuant to an existing commitment to loan additional funds.

L.B. 14 recognizes the need for certainty in real estate finance and (1) sets forth a basis for the parties to a real estate loan to agree by contract to the creation of a security interest in rents; (2) resolves the

Sec. 3. A security interest in rents shall be valid and binding between the parties to an assignment instrument upon the execution and delivery of the assignment instrument by the assignor to the assignee.

Sec. 4. A security interest in rents shall be perfected upon the recording of an assignment instrument with the register of deeds in the county in which the real estate, or any part thereof, described in the assignment instrument is situated. Upon the recording of the assignment instrument, the security interest in rents shall be valid, enforceable, and binding against, unavoidable by, and fully perfected as to all parties, including any subsequent purchaser, mortgagee, trustee in bankruptcy, general creditor, lien creditor, and other lienholder or claimant, from the time of the recording of the assignment instrument. It shall not be necessary for an assignee to take actual or constructive possession or control of the real estate or rents related thereto, to secure the appointment of a receiver, to take any action tantamount to taking of such possession or control, or to take any other action whatsoever to perfect a security interest in rents.

Sec. 5. An assignee may enforce a security interest in rents by (1) the appointment of a receiver under applicable law, (2) the recovery of rents as part of the enforcement of an assignment instrument, or (3) as provided in section 6 of this act or under other applicable law. The collection of rents by an assignee in accordance with section 6 of this act shall not be deemed to impose the obligations of a mortgagee or any other person in possession of the real estate on the assignee.

Sec. 6. If agreed in an assignment instrument or on default by the assignor whether agreed in the assignment instrument or not, the assignee shall be entitled to notify any rent party to make payment of rents due or to become due to the assignee whether or not the assignor was previously receiving or collecting rents. A rent party may pay rents to the assignor until the rent party receives notification that the rents due or to become due have been assigned and that payment is to be made to the assignee. If requested by the rent party, the assignee shall furnish reasonable proof that the assignment has been made, and unless the assignee furnishes the proof, the rent party may pay the assignor. A term in any lease between a rent party and an assignor is ineffective if it prohibits assignment of a lease or rents due or to become due pursuant to the lease, if it prohibits creation of a security interest in rents due or to become due, or if it requires the consent of the rent party to such assignment or a security interest in rents.

Sec. 7. Priority between conflicting security interests in rents shall be ranked according to priority in the time of recording of an assignment instrument.

Sec. 8. Sections 1 to 7 of this act shall be applicable to any assignment instrument properly recorded prior to, on, or after the effective date or this act.

Sec. 9. That section 76-276, Reissue Revised Statutes of Nebraska, 1943, be amended to read as follows:

76-276. In the absence of stipulations to the contrary, the mortgagor of real estate retains the legal title and right of possession thereof. This section shall not limit or otherwise affect the creation, provision, assignment, granting, or enforcement of a security interest in rents arising from real estate pursuant to sections 1 to 8 of this act.

Sec. 10. That original section 76-276, Reissue Revised Statutes of Nebraska, 1943, is repealed.

Sec. 11. Since an emergency exists, this act shall be in full force and take effect, from and after its passage and approval, according to law.

Id.

issues of perfection that can exist in the context of a mortgagor's bankruptcy case; (3) establishes a nonjudicial procedure for the enforcement and collection of rents; and (4) establishes the priority between competing security interests in rents.¹⁹

A. DEFINITIONS

L.B. 14 is driven by a series of definitions which define the parties and other key concepts. The starting point is the definition of "rents," which is defined as "any right to income, rents, proceeds, issues, profits, royalties or any other payment or benefit derived under a present or future lease."²⁰ Other key definitions include: (1) "Lease," defined as "any license, lease, contract or other agreement for the use or possession or [sic] real estate";²¹ (2) "assignor," defined as the party granting the security interest;²² (3) "assignee," defined as the secured party;²³ and (4) "rent party," defined as the person obligated to pay rent under the lease.²⁴

B. CREATION OF A SECURITY INTEREST IN RENTS AND OBLIGATIONS SECURED

L.B. 14 permits the creation of a security interest in rents by means of an "assignment instrument," which is defined as "any mortgage, trust deed, assignment of leases, assignment of rents or any other instrument or agreement which creates, provides, assigns or grants a security interest in rents."²⁵ Under L.B. 14, the assignment instrument may secure all obligations, including future advances, and may provide that the obligations are secured by all "present, future, or after arising rents or leases."²⁶

It is not necessary for a lender to acquire an interest in the real estate by means of a mortgage or trust deed in order to have a security interest in rents. The security interest in rents can be created by a separate assignment of rents or by any document that would qualify

19. L.B. 14 covers rents payable under a lease. L.B. 14 does not attempt to create or extend any claim of a mortgagee to property interests other than leases and rents payable thereunder. Mortgagees have asserted claims to crops grown on encumbered land based on "rents and profits" clauses. Crops, whether growing or harvested, are personal property. Thus, any security interest in personal property should be governed by Article 9 of the U.C.C., and not by real estate law. *United States v. Newcomb*, 682 F.2d 758 (8th Cir. 1982); *In re Temple Stephens Co. Inc.*, 156 B.R. 38 (Bankr. W.D. Mo. 1993).

20. L.B. 14, *supra* note 18, § (1)(6).

21. *Id.* § (1)(4).

22. *Id.* § (1)(3).

23. *Id.* § (1)(1).

24. *Id.* § (1)(5).

25. *Id.* § (1)(2).

26. *Id.* § (2).

as an "assignment instrument." Correspondingly, a party intending to provide financing secured by real estate must now be very careful to check the real estate records and review not only recorded mortgages, but any separate assignment instruments that may be a prior recorded interest in rents.

C. RECORDING AND PERFECTION

An assignment instrument is valid and binding between the parties. In order to perfect a security interest in rents and obtain priority over prior unrecorded interests, subsequently recorded interests, or a trustee in bankruptcy, L.B. 14 requires that the assignment instrument be recorded with the register of deeds in the county where the real estate "or any part thereof . . . is situated."²⁷ Once the assignment instrument is recorded, the security interest in rents is deemed "valid, enforceable, and binding against, unavoidable by, and fully perfected as to all parties, including any subsequent purchaser, mortgagee, trustee in bankruptcy, general creditors, lien creditor, and other lienholder or claimant."²⁸

D. RETROACTIVE EFFECT

L.B. 14 specifically provides that it is applicable to all assignment instruments that are "properly recorded prior to, on, or after the effective date of the act."²⁹ L.B. 14 became effective on February 16, 1993. Accordingly, a mortgage, trust deed, or other assignment instrument recorded prior to the effective date that contains the appropriate grant of a collateral interest in rents would be effective to create a security interest in rents under L.B. 14. Under a mortgage, trust deed, or assignment instrument recorded prior to the effective date, the lender would be able to employ the aforementioned enforcement mechanisms.³⁰

27. *Id.* § (4).

28. *Id.* Although the statute provides that a recorded assignment instrument is perfected and "unavoidable" by a trustee in bankruptcy, the recorded assignment instrument would still, under appropriate factual circumstances, be subject to the avoidance provisions of 11 U.S.C. §§ 547, 548. For example, an assignment instrument recorded within 90 days of the filing of a bankruptcy case could be subject to avoidance under § 547 of the Bankruptcy Code. Under L.B. 14 an interest in rents is perfected at the time of recording and as such would be unavoidable by the trustee in bankruptcy under § 544 of the Bankruptcy Code, which generally permits a trustee to avoid a security interest that is "unperfected" under applicable state law. 11 U.S.C. § 544(b) (1988).

29. L.B. 14, *supra* note 18, § 8.

30. The retroactive provisions may, in some limited instances, change the relative order of priority as to the real estate. For example, assume that the real estate is subject to two prior recorded mortgages, and the first recorded mortgage does not contain a grant of an interest in rents, while the second recorded mortgage does contain a grant of an interest in rents. Under applicable real estate law priority, the first mortgagee

E. PRIORITY

L.B. 14 adopts a basic "first to file" rule for purposes of priority.³¹ The assignor that first files an assignment instrument will have priority over prior unrecorded interests or subsequent recorded interests. This provision should be viewed as a "pure race" priority scheme with knowledge of any prior unrecorded interest being deemed irrelevant for priority purposes. A properly recorded assignment instrument has priority over subsequent purchasers and any subsequent holder of an assignment, trust deed, or mortgage.

F. ENFORCEMENT OF A SECURITY INTEREST IN RENTS

As discussed above, prior to the adoption of L.B. 14, the general rule in Nebraska was that the party-in-possession was entitled to retain the rents, and the mortgagee needed either to obtain the appointment of a receiver or become a mortgagee-in-possession. L.B. 14 eliminates the process of obtaining the appointment of a receiver in order for a lender to collect or recover rents.³² L.B. 14 specifically provides that it is not necessary for an assignee to take actual or constructive possession of the real estate, obtain the appointment of a receiver, or take any other action tantamount to taking possession or control in order to perfect an interest in or obtain the rents.³³

Although under L.B. 14 the assignee retains the option to enforce a security interest in rents through the appointment of a receiver under applicable law or by other judicial proceedings, the appointment of a receiver or other judicial proceedings are no longer mandatory. L.B. 14 now permits nonjudicial enforcement of a security interest in rents by notification to the rent party.

L.B. 14 provides that if it is agreed in an assignment instrument, or in any event upon default, the assignee has the right to notify any "rent party" to make rent payments directly to the assignee.³⁴ The

would be entitled to receive the proceeds of any sale of the real estate in the event of a foreclosure before the second mortgagee received any proceeds. However, under L.B. 14 the second mortgage holder would have first priority to any rents.

31. L.B. 14, *supra* note 18, § 7.

32. *Id.* §§ 5, 6.

33. The elimination of the necessity of seeking the appointment of a receiver is of particular benefit to lenders using trust deeds. If the collateral instrument is a mortgage, then the lender would seek judicial enforcement and in that action could seek the appointment of a receiver. However, under a trust deed, the enforcement is nonjudicial, and the trust deed beneficiary would have to commence a separate action and comply with the applicable receivership statutes in order to obtain a receiver and control over the rents.

34. The provisions of L.B. 14, which permit the enforcement of a security interest in rents through a notification system, are analogous to the notification of account debtors and collection of accounts under U.C.C. §§ 9-318, 9-502.

assignor may effectuate the collection of rents in the absence of an event of default if permitted under the assignment instrument or after an event of default, even though the assignment instrument may not specify the ability to collect rents after an event of default.

The rent party is entitled to pay the rent to the assignor until the rent party has received notification that the rents are to be paid to the assignee. If the rent party receives a notification from the assignee, then the rent party is obligated to pay the assignee. The rent party may request that the assignee furnish reasonable proof that there has been an assignment of the rents, and unless the assignee provides such proof, the rent party may continue to pay the assignor. If the rent party continues to make the rent payments to the assignee after receiving notification and fails to request reasonable proof or makes the request and receives reasonable proof, then the rent party would remain liable to the assignee and would in effect have to "pay twice."

The lease between the rent party and the assignor may contain a provision that prohibits the assignor from assigning the lease or rents. L.B. 14 provides that such a prohibition is ineffective.³⁵

CONCLUSION

Legislative Bill 14 ("L.B. 14") provides a simplified and streamlined system for the creation, perfection, and enforcement of a security interest in rents. L.B. 14 recognizes the economic realities of commercial real estate financing where the focus may be more upon the income stream generated by the real estate, as opposed to the value of the underlying real estate. Furthermore, L.B. 14 eliminates issues with respect to perfection of a security interest in rents, particularly in the event of an assignor's bankruptcy. Also, by providing a notification system for collection, L.B. 14 significantly reduces the expense and delay in the enforcement of a security interest in rents in the event of a default. L.B. 14 should create and enhance certainty in the financing of real estate projects.

35. A similar prohibition against the effectiveness of an antiassignment clause is contained in U.C.C. § 9-318(4).