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Title

Hotel room revenues in Texas: Are they real property now that Texas has enacted the Texas Assignments of Rents Act?

Overview

Under the Texas Assignment of Rents Act ("**TARA**")[1], hotel room revenues are, arguably, no longer personal property under Texas law. Hotel room revenues will likely be characterized as "rents," or real property, when these revenues are pledged as collateral for loans.

Hotel Room Revenues – Real Property or Personal Property?

I. Hotel Loans - Generally

A hotel is comprised of real property and a reasonable amount of personal property. The personal property component can often account for 25% or more of the cost or value of the hotel. The presence of both real and personal property creates a "mixed collateral" situation with challenging legal implications for lenders. Obviously, a hotel lender needs the mortgage or deed of trust that any real estate lender typically requires. The lien evidenced by the deed of trust becomes effective against other creditors when filed of record in the real property records of the county where the real property is located. But typical real estate liens and insurance are not adequate for a hotel's substantial personal property. For the personal property elements, hotel lenders often obtain, among other things, a separate security agreement granting a security interest in personal property associated with the hotel which is covered by Article 9 of the Uniform Commercial Code ("**UCC**"), including accounts, fixtures, equipment, software, and other tangible and intangible personal property. The security interest is perfected against the claims of other creditors by filing a UCC-1 financing statement in the place designated by the UCC (except for fixtures, the proper place for recording is typically the secretary of state's office of the state where the borrower is registered as an organization). The failure to properly describe the collateral or record a deed of trust or UCC-1 financing statement could result in the loss of collateral security that the lender relied upon in making the loan.

II. Accounts vs. Rents.

[1] TARA was adopted by the passage of Senate Bill 889 during the 82nd Legislature and became effective on June 17, 2011. Act of June 17, 2011, 82d Leg., R.S., S.B. 889 (amending Tex. Bus. & Com. Code Ann. § 9.109 and to be codified at Tex. Prop. Code Ann. ch. 64).

Prior to the 1980's, hotel revenues were typically considered to be “rents, profits, and proceeds” of real property for purposes of assignments of rents and security agreements recorded in connection with hotel mortgages.[2] As such, hotel revenues were generally available to a secured lender as cash collateral following the commencement of bankruptcy proceedings. In the late 1980's and early 1990's, the characterization of hotel revenues as rents was increasingly challenged, and in a series of bankruptcy court decisions, hotel revenues began to be characterized as payments for services rendered, not rents, profits or proceeds, and were treated accordingly as accounts receivable, or “accounts,” subject to Article 9 of the UCC. Under this characterization, to ensure perfection of a security interest in post-petition hotel revenues following the borrower’s bankruptcy, a lender would be required to file a UCC-1 financing statement that included "accounts" within its collateral description, rather than merely record an assignment of rents under a deed of trust. As a result, lenders that merely perfected a lien on rents pursuant to an assignment of rents in a deed of trust were unable to enforce their lien on hotel revenues generated post-petition. In some cases, lenders relying on security agreements covering the hotel debtor's accounts also were not fully protected as to post-petition revenues. Some courts held that the security interest in this instance attached only to accounts receivable in existence as of the date of the bankruptcy, but did not attach to accounts arising post-petition.

To address these problems, Section 552(b)(2) of the Bankruptcy Code was amended in 1994 to provide that if a pre-petition security agreement created a security interest in “fees, charges, accounts, or other payments for the use and occupancy of rooms and other public facilities in hotels, motels or other lodging properties,” then the security interest extended to the same property acquired by the debtor after the commencement of bankruptcy to the extent provided in the security agreement, unless the court orders otherwise. If these conditions are not met, the revenues are treated as cash collateral under revised Section 363(a) of the Bankruptcy Code and available to the debtor. As such, the lender, as secured creditor may not use them without the permission of other creditors or without providing adequate protection to creditors under Sections 363(c)(2) and 363(e). In situations where Section 552(b)(2) applies, bankruptcy courts may, based upon the equities, elect to allow the debtor or other creditors to use hotel revenues to keep the operation going or merely to address priority concerns among the creditors.

While helpful in eliminating ambiguities post-petition, amended Section 552(b)(2) did not resolve uncertainties under state law regarding the proper characterization of hotel revenues and the appropriate means of perfecting a security interest in or lien on these revenues.[3] Section 552(b)(2) allows a security interest in post-petition lodging revenues without regard to whether the interest is perfected under state law. The Bankruptcy Code, as amended, does not resolve priority disputes among several secured creditors. Secured creditors must continue to ensure that their interests are properly perfected under the requirements of state law to protect themselves against the claims of other secured parties. Furthermore, the Bankruptcy Code modifications are limited specifically to lodging revenues and do not extend to other types of similar “rental” operating income, such as revenues from casinos, golf clubs, and marinas.

[2] *See, e.g.,* In re Days California Riverside Ltd. P'ship, 27 F.3d 374 (9th Cir. 1994) (holding that under California law, hotel room revenues, net of the portion of revenues derived from the sale of food and drink and other hotel services, constitute rent); In re B.F. Drake Hotel Assocs., 131 B.R. 156 (Bankr. N.D. Cal. 1991) (interpreting Florida law, holding post-petition revenue generated from occupancy of hotel rooms constitute rents subject to a deed of trust).

[3] *See* Butner v. U.S., 440 U.S. 48, (1979); the Supreme Court unanimously held that **state law** was determinative in disputes between a bankruptcy trustee and a mortgagee over the rights to the rents collected post-petition.

The portion of a hotel fee paid by a guest for the right to occupy and use a room is clearly covered under the revised Bankruptcy Code; however, the debate continues under both the Bankruptcy Code and state law as to that portion of a hotel fee attributable to hotel services and amenities such as maid service, cable television, health clubs, pools, access to computers and fax machines, access to a nationwide reservation system, access to meeting rooms and banquet facilities, and concierge services, for example. Thus, while the amendments substantially improve the position of a properly secured lender by significantly reducing the amount of hotel revenues potentially in dispute, the issues which the amendments sought to address are not fully resolved.

III. Hotel Receipts under State Law – Personalty or Realty?

When bankruptcy law is not applicable, State law governs the characterization of hotel receipts as either personalty (i.e., accounts) or realty (i.e., rents) and how to achieve proper perfection of an interest in those receipts against the claims of other creditors.[4] In jurisdictions where case law is not certain on this issue, it is the preferred practice to both record the mortgage or deed of trust granting the lender a lien on rents and obtain a security agreement and file a UCC-1 financing statement in accordance with the applicable UCC.

Most State courts have classified hotel revenues as UCC **personalty** for purposes of perfection of a security interest in such income. **These courts apply conclude that hotel guests occupy their rooms as licensees rather than as tenants under leases, and therefore do not obtain an interest in the real property**. In reaching this conclusion, these courts often look to the exclusion of transient hotel occupancy from the particular jurisdiction's residential landlord/tenant statutes.

In contrast, a few State courts have applied a dominant source standard to classify hotel room revenues as realty because the revenues are "undeniably" generated from the use or occupancy of real property.

The classification of hotel room revenues as real estate rents or as accounts determines what procedures must be followed to perfect and maintain the security interest or lien. If hotel room revenues are "accounts" and therefore interests in personalty, state UCC perfection requirements must be met. The UCC, which applies only to interests in personalty, provides that such interests may be perfected by filing a financing statement describing the collateral in the place prescribed by the applicable UCC. In most instances, when the borrower is a legal entity with organizational documents filed with a state, the proper place to file is the office of the secretary of state in the State where the debtor is organized.

If, on the other hand, hotel room revenues are characterized as real estate "rents," UCC perfection requirements do not apply. Rather, State real property recording laws must be followed: Interests in real estate are perfected solely by filing documents describing the real property interest with the recorder's office in the county where the realty interest is located.

IV. Texas Law Prior to TARA

[4] *See id*. Interests in real property, including rents, are created and defined in accordance with the law of the situs of the real property. In re Jason Realty, L.P. 59 F.3d 423, 427 (3d Cir. 1995) (citing Butner v. United States, 440 U.S. 48, 55 (1979); Commerce Bank v. Mountain View Village, Inc., 5 F.3d 34, 37 (3d Cir. 1993)).

Prior to the effectiveness of TARA, Texas followed the majority of States in holding that hotel room revenues **are accounts under the UCC**.[5] *In Re Corpus Christi Hotel Partners*, an oft-cited bankruptcy case, holds that post-petition hotel room charges are after-acquired accounts (personal property) and are neither "rents," "profits," nor "proceeds" of the land.[6] In applying Texas law, the judge stated: "In Texas the term 'rent' refers to the landlord/tenant relationship and not to the innkeeper/lodger relationship. The general rule is that a tenant is vested with an estate in the property while a hotel guest is not."[7] In the ordinary landlord/tenant relationship, monies paid by an occupier under a lease to the owner-mortgagor are rents; and a lease is a possessory interest in land.[8] A license agreement, however, might produce income that is not part of the rental stream. And the judge in *In Re Corpus Christi Hotel Partners* ruled that a hotel guest is a licensee under Texas law.[9]

V. Enactment of TARA

TARA eliminates the absolute assignment of rents in Texas. An absolute assignment of rents "purports to transfer title to rents to the mortgage lender, although in substance it creates a security interest in rents."[10] TARA amends Article 9 of the UCC and creates a new Chapter 64 in the Texas Property Code. TARA is intended to provide basic rules that establish a "security interest" in rents, the rights of real property tenants to notice and the effect of notice, and the priority of the security interest against other creditors. Under TARA, an enforceable security instrument automatically creates an assignment of rents, unless (i) the security instrument expressly provides otherwise, or (ii) certain provisions of the Texas Constitution dealing with home equity loans or homesteads control.[11] The effect is to make it clear that any deed of trust or mortgage that provides a creditor with a security interest in real property will also provide a security interest in the rental income of that property.

Prior to the enactment of TARA, rent assignees were able to obtain possession of rents in accordance with the rules set forth in Taylor v. Brennan[12] -- an assignments of rents became operative when the beneficiary under a deed of trust obtained possession of the property, secured the appointment of a receiver, or took similar action.[13] Under TARA, additional methods are granted to secured parties to enforce their security interest in rents -- an assignee of rents may (i) obtain direct payment of rents from tenants by providing notice or (ii) notify the

[5] *See* In re Corpus Christi Hotel Partners, Ltd., 133 B.R. 850 (Bankr. S.D.Tex.1991) ("The general rule is that a tenant is vested with an estate in property while a hotel guest is not").

[6] *See id.*

[7] *See id*., 133 B.R. 850, 854; *see also* Mallam v. Trans-Texas Airways, 227 S.W.2d 344, 346 (Tex.Civ.App.-El Paso 1949, no writ); In re Waco Hotel Limited P'ship, No. 6-86-00298 (W.D.Tex. July 16, 1986) (order on room receipts).

[8] *See id.*

[9] *See id.*

[10] *See* Julia Patterson Forrester, *Still Crazy After All These Years: The Absolute Assignment of Rents in Mortgage Loan Transactions*, 59 FLA. L. REV. 3, 487 (2007).

[11] *See* Tex. Prop. Code Ann. 64.051 (2011). It is no longer necessary to provide for an assignment of rents in a security instrument covering real property; an assignment of rents arises by statute, unless it is expressly disclaimed.

[12] *See* Taylor v. Brennan, 621 S.W. 592, 594 (Tex. 1981).

[13] *See id.*

assignor directly, in which case the assignor is then required to pay proceeds of rent collection to the assignee directly.[14]

TARA is largely based on the Uniform Assignment of Rents Act ("**UARA**")[15], adopted by the Uniform Law Commission in 2005. Section 2(12)(a) of UARA defines "Rents," among other things, as:

> "(a) sums payable for the right to possess or occupy, or for the actual possession or occupation of, real property of another person."

The commentary to UARA indicates that the term "rents" includes hotel room revenues.[16]

The definition of "rents" under TARA is even broader than UARA's definition. Section 64.001(9)(A) of the Texas Property Code defines "rents," among other things, as:

> (A) consideration payable for the right to possess or occupy, or for possessing or occupying, real property;[17]

Given that "rents" under TARA is defined very broadly to include "consideration" payable for the right to possess or occupy real property, as opposed to UARA's slightly narrower use of "sums"[18] payable for the right to possess or occupy real property, it is reasonable to conclude that under TARA, "rents" includes hotel revenues.[19] It should be noted that while UARA contains extensive notes, comments, and a prefatory note with illustrations and examples, TARA contains none of these explanatory sidebars.[20] Accordingly, Texas courts will interpret TARA on its plain language without having the benefit of the UARA comments, although it is

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[14] *See* Tex. Prop. Code Ann. §§ 64.054-.055 (2011).

[15] *See* Uniform Assignment of Rents Act §§ 1-21, 7 (Pt. IB) U.L.A. 7 (2005).

[16] *See* In re Ocean Place Dev., L.L.C., 447 B.R. 726, 735 n. 8 (Bankr. D. N.J. 2011): "The Court is cognizant that under a draft of the Uniform Assignment of Rents Act ("**UARA**"), adopted by the Uniform Law Commission in 2005, 'rents' would include security interests in hotel room revenues." UARA states that "the Act establishes that rents include any sum paid by a tenant, licensee, or other person for the right to possess or occupy the real property of another."; *see also* UARA, Prefatory Note, Illustration 2: "ABC Life Insurance Company holds an assignment of rents on the Friendly Hotel. Heinsz is a guest of Friendly Hotel for three nights. Although Heinsz has no possessory interest in a particular hotel room vis-a-vis the owner of Friendly Hotel, Heinsz does "occupy" the room in a fashion that essentially excludes third persons. **Sums payable for the room occupancy charges that Heinsz incurs for his stay are 'rents.**' Sums payable for charges that Heinsz incurs for additional hotel-related services (such as room service meals, dry cleaning or laundry services, or the like) would not constitute 'rents,' as they are not incurred in exchange for the right to occupy the room." For further background, see UARA § 2, Preliminary Comment 12.

[17] *See* Tex. Prop. Code Ann. 64.001(9)(A) (2011).

[18] The drafters of TARA elected to use "consideration" instead of "sums" because "we wanted it to include all types of payment and that we thought it was a more clearly understood legal term." E-mail from Julia Patterson Forrester, Professor of Law, Southern Methodist University, to Allen J. Dickey, Attorney, Munsch Hardt Kopf & Harr, P.C. (June 29, 2011, 21:12 CST) (on file with author).

[19] Professor Julia Forrester, one of the drafters of TARA, concurs: "…'rents' under TARA are definitely intended to include hotel room revenues, boat slip fees, and other such payments for the right to possess or occupy real property…" *See Id.*

[20] *See* Edward Walker, *The Texas Assignment of Rents Act,* State Bar of Texas Annual Meeting, Real Estate, Probate and Trust Law Section Hot Topics and Update Program, Friday, June 11, 2010., p. 5: "UARA contained extensive commentary and examples in each section. These were deemed by the committee to be inapplicable to Texas and were deleted. Texas courts and practitioners should not refer to the official comments to UARA when seeking guidance in the interpretation of TARA."

conceivable that Texas courts will give deference to the UARA commentary, as they currently do with regard to the Official Comments to the UCC. That being said, as TARA's definition of rents is arguably broader in scope than UARA's, and with courts such as the Third Circuit and the UARA itself taking the position that the UARA's definition of "rents" includes hotel revenues, it's hard to imagine that Texas courts will continue to rule that hotel room revenues are "accounts" under the UCC.

VI. Conclusion

Under Texas law prior to TARA, fees paid by a licensee to a licensor did not constitute "rents." Hotel guests in Texas are deemed to be licensees. As a result, prior to TARA, hotel room rentals did not constitute rent in Texas, but instead were characterized as “accounts” that could be encumbered only by obtaining a security interest under the UCC .[21] But the enactment of TARA has provided a statutory definition of rents that includes hotel revenues, thereby calling into question the efficacy of loan documents that merely encumber hotel revenues as personal property accounts.

Although TARA appears to have changed the proper characterization of hotel room revenues, lenders in Texas should not rely on that result with certainty just yet. Until a Texas court rules definitively on this issue post-TARA, the prudent course of action for lenders would be to (A) assume hotel room revenues are rents subject to TARA and specifically include them as collateral security under (i) a Deed of Trust and Assignment of Leases and Rents properly recorded in the county where the real property is located or (ii) a separate Assignment of Leases and Rents recorded in the county where the real property is located,[22] and (B) execute a security agreement in accordance with the UCC covering present and future accounts, with a financing statement describing accounts as the collateral, recorded in the appropriate UCC filing office. This “belt and suspenders” approach would appear to give the lender a perfected security interest in unaccrued hotel occupancy revenues, regardless of how Texas law resolves the “realty or personalty” classification question once and for all. Of course, the duplicate preparation and recording costs involved with this approach increases transaction costs with respect to the origination of such loans. These increased costs should be eliminated in the future once Texas courts look to TARA to resolve the classification dilemma of hotel room revenues.

[21] *See generally*, Amanda L. Burcham, *Texas Should Adopt The Uniform Assignment of Rents Act: A Comprehensive Statute To Eliminate The Technical Constructions Of State Mortgage Law And Secure Lenders' Access To Pledged Rents*, 60 SMU L. R. 579 (2007).

[22] Since TARA eliminates absolute assignments of rents, there is even less reason to have a separate assignment of leases and rents.