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Real Estate Newsletter

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# THE TEXAS LEGISLATURE MAY HAVE JUST REWRITTEN YOUR REAL ESTATE LOANS

**ATTENTION LENDERS, LANDLORDS AND COMMERCIAL TENANTS:**

The Texas legislature just rewrote all real estate loan documents in Texas which include an assignment of rents to the lender (and almost all commercial real estate loans do) when it passed the new Chapter 64 of the Texas Property Code. The Governor signed the bill on June 17, and the law is effective immediately.

*What does this mean to you?*

LANDLORDS: As of now, a landlord cannot collect rents after its lender gives it notice of default and demands the rents and must turn over any rents it collects to the lender. The landlord can keep the rents already collected except pre-paid rents.

COMMERCIAL TENANTS: As of now, a commercial tenant should not pay the landlord rent after it receives notice from the landlord's lender demanding the rents, or the tenant may have to pay rent twice.

LENDERS: The "absolute assignment" in Texas real estate loans is dead and the new law supersedes the terms of your loan documents

Here are some KEY FEATURES of a new Texas law, *which applies to all existing real estate loan transactions*:

- all assignments of rents executed in connection with real estate loans are security agreements, even if they are in the form of an absolute assignment;
- the assignment of rents is perfected when the deed of trust is recorded;
- upon default, the lender is entitled to collect all uncollected rents and all pre-paid rents from the borrower by giving the borrower proper notice; the borrower is entitled to keep rents already collected, except for pre-paid rents that accrue on or after the date the lender gives notice;
- upon default, the lender is entitled to collect all unpaid rents from commercial tenants and the tenants will remain liable for the rent if they pay the borrower/landlord instead of the lender after receiving proper notice; and
- using the proper method and address for giving notice is critical under the statute, but parties can specify the method and address for notice and agree to the use of electronic notice.

See more HIGHLIGHTS following the discussion below.

New Chapter 64 of the Texas Property Code, entitled

"Assignment of Rents to Lienholder"[2] defines the parties' rights to rents in real estate loan transactions. The new law applies to all existing assignments of rents in real estate loans and supersedes any terms in the documents which are inconsistent with the statute but there are areas where the parties can agree to vary from the statute. As a result, we can expect attorneys to substantially rewrite loan documents, as well as leases and agreements between lenders and tenants, such as subordination and attornment agreements; consequently, all parties will need to understand how the new law and the revised documents will affect them.

One of the most confusing and highly litigated areas of Texas law has been the relative rights of lenders, borrowers and tenants under assignments of rents entered into as part of a real estate loan transactions. The new Chapter 64 to the Texas Property Code, which became effective on June 17, 2011, brings much needed certainty to this area of law and balances the rights of the parties.

Texas law has now aligned itself with the majority of states which interpret the common law to be that an assignment of rents executed as security for a real estate loan is *always* an assignment of a security interest in rents, or a collateral assignment, even if the document is in the form of an absolute assignment. An absolute assignment typically states that title to the rents is immediately transferred to the lender but that the lender grants the borrower a license to collect and use the lender's rents until there is a default. Under the new law an "absolute assignment" of rents to a lender with a lien on real property is deemed a security interest, not a transfer of title to the rents. As discussed below, the new law clearly defines the parties' rights when a borrower defaults.

Historically, the rights of parties under the common law were often determined by who had title to property, with grave consequences to borrowers who transferred title to a lender as security for a loan. Often, if a borrower defaulted, the lender would effectively keep the property, regardless of the amount of the debt or the borrower's equity in the property. When the Uniform Commercial Code was adopted over 40 years ago, it introduced a fundamental advance in the law of commercial transactions by adopting the modern principle that the reality of the transaction should trump any legal device that lawyers could create to subvert the true intent of the parties. So when a borrower assigns an interest in personal property as security for a debt under Article 9 of Uniform Commercial Code, title to the collateral stays with the borrower prior to foreclosure, regardless of whether the security agreement states that title is transferred to the lender immediately. Upon default, the lender must dispose of the collateral in a reasonably commercial manner and is limited to recovering its debt and costs of enforcing its rights from the proceeds of the disposition of the property.

However, the UCC excluded security interest in *rents*, leaving the interpretation and enforcements of assignments of rents to the common law. As a result, lenders typically included "absolute assignments" of rents in real estate loan documents. Under these "absolute assignments" of rents, the lender claimed to own the rents and, therefore, had the right to effectively take control of the property upon default and prior to foreclosure by revoking the license and preventing the borrower from using the rents to operate the property or restructuring the debt in bankruptcy.

In most states, the courts held that these "absolute assignments' were legal fictions and were, in reality, nothing more than security interests and so title remained in the borrower. But in other states, such as Texas, court decisions, particularly federal and bankruptcy court decisions interpreting Texas law, reached conflicting results, creating continuing uncertainty and sparking litigation.

Moreover, because the common law does not provide for filing a security interest to perfect a security interest in rents, considerable controversy arose as to how the lender could exercise its right to the rents upon default, whether the lender was entitled to the rents already collected, and how the rights of tenants caught in the crossfire were affected.

That is all history in Texas, as of June 17, 2011, the effective date of the new Chapter 64 to the Texas Property Code.[3]

Here are some HIGHLIGHTS of the new law:[4]

- The Act retroactively governs the enforcement, perfection and priority of a security interest in rents, and the attachment and perfection of a security interests in the proceeds.[5]
- An assignment of rents in a real estate loan transaction creates a security interest in accrued and unaccrued rents relating to the real property regardless of whether the assignment is in the form of a collateral or absolute assignment of rents.[6]
- An assignment of rents is not effective in a home equity loan or a reverse mortgage[7] and cannot be enforced against a against the borrower's homestead if the homestead is a one to four family dwelling and the property was the borrower's homestead both when the assignment was executed and when the enforcement action is taken.[8]
- "Rents" includes "consideration payable for the right to possess or occupy, or for possessing or occupying real property."[9]
- The security interest is perfected when the document creating the assignment is filed in the county where the real property is located and takes priority over subsequent liens on the real property.[10]
- The lender automatically has a security interests in rents under any deed of trust filed on or after June 17, 2011, regardless of whether the deed of trust specifically includes an assignment of rents.[11]
- After default, the lender can enforce the assignment by: (1) giving notice to the borrower, (2) giving notice to the tenants, and (3) exercising other remedies under Texas law (such as seeking the appointment of a receiver).[12]
- Upon giving notice, the lender is entitled to all uncollected rents and all pre-paid rents. The lender is not entitled to rents already collected by the borrower, except for pre-paid rents that accrue on or after the date the lender gives notice. The tenant is not obligated to pay to the lender any rent that was prepaid to the borrower (*i.e*. the landlord) before the tenant received notice from the lender.[13]
- The lender's security interest in rents extends to identifiable cash proceeds either in a segregated account or in a commingled account to the extent

the proceeds can be traced under methods of tracing, including equitable principles, allowed by Texas law.[14]

- If the borrower collects rents which the lender is entitled to collect, the borrower must turn those rents over to the lender within 30 days after receiving the lender's notice or such other time as required by the agreement, less any amount for expenses authorized by the agreement.[15]

- If the borrower does not turn over the rents, the lender can sue the borrower for the rents and for attorneys' fees provided under the assignment.[16]

- If a lender enforces the assignment by notifying the tenants to pay the lender, the lender must use the form of notice specified in detail in the statute and must be signed by the lender's agent.[17]

- After the tenant receives the notice, the tenant is obligated to pay rent to the lender and cannot satisfy its obligation to pay rent by paying the landlord (unless the property is the tenant's primary residence).[18]

- If the property is the tenant's primary residence, the tenant can discharge his or her obligation to pay rent by paying either the lender or the borrower, *i.e.* the landlord).[19]

- The lender does not have an obligations to use the rents to protect or maintain the property (unless otherwise agreed in writing)[20] but the tenant retains any claims or defenses to paying rent that it otherwise has under its lease or under the law, unless the tenant agrees otherwise.[21]

- The tenant is not in default under the lease for non-payment of rent accruing during the 30 days after the tenant receives notice until the earlier of (1) 10 days after the next rent payment is due, or (2) 30 days after receiving the notice, unless the tenant has signed a document providing otherwise.[22]

- The tenant is required to continue paying rents to the lender until the tenant receives a signed document from the lender canceling the notice, a court order, or a signed notice that a lender with a superior lien has foreclosed on the property.[23]

- The statute does not mention the affect of a bankruptcy filing by the borrower/landlord on the tenant's obligation to pay rent to the lender. Under bankruptcy law, the rents are property of the bankruptcy estate[24] and all parties are automatically enjoined from exercising control over property of the estate.[25] Lenders may be well advised to rescind the notice upon the borrower's filing bankruptcy to avoid the imposition of sanctions,[26] and borrowers may be well advised to immediately obtain a bankruptcy court order directing tenants to pay rent to the borrower.

- The statute allows notice to parties by certified mail, regular mail or *by any means agreed to by the intended recipient of the notice.* To the extent the statute requires that a notice be signed, the signature can be an electronic signature.[27]

- Generally, the lender can apply the proceeds to the reimbursement of reasonable attorneys' fees and costs of collection, reimbursement of expenses it incurs in protecting or maintaining the property, payment of the secured obligation, payment of subordinated secured creditors who give the lender

notice, and any balance to the borrower.[28]

A key feature of the statute is that the rights of the lender, borrower, and tenant are fundamentally affected by notice as specified in the statute. The statute provides flexibility to lenders, borrowers and tenants to agree on means of notice, including electronic notice, as well as to define the address for notice, and to vary the relative rights between the lender and the tenant upon the borrowers default. Because the rights of the parties are fundamentally affected by notice under the statute, it is critical that the notice agreed upon in the documents serves to provide *actual* notice to the intended recipient. For example, the tenant is legally obligated to pay rent to the lender upon receiving effective notice under the statute but the tenant is frequently not a party to an agreement with a lender. The statute provides that, under some circumstances, the lender can use the same means of notice the landlord is required to give the tenant under the lease even though the lender is not a party to the lease. Tenants will want to make sure that the notice provisions in the lease provide them actual notice and lenders may want to add provisions to assignments of rents requiring that leases on the property contain specific notice provisions acceptable to the lender.

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[1] Unless the landlord filed for protection under Chapter 11 of the United States Bankruptcy Code. [2] Senate Bill was signed by Governor Perry on June 17, 2011 and is effective immediately. The text of the bill can be found at http://www.capitol.state.tx.us/BillLookup/Text.aspx?LegSess=82R&Bill=SB889.

[3] For the effective date, go to Texas Legislature Online at http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB889

[4] Readers are cautioned that the author is paraphrasing the complex provisions of the new law to provide readers a general understanding, and that they should not rely on this article for specific legal advice but should seek the assistance of counsel. The author has taken the liberty of substituting the terms “borrower” and “lender” for “assignor” and “assignee” respectively.

[5] S.B. No. 889 § 3(a).

[6] § 64.051(a) and (b).

[7] § 64.051 (a); Tex Const. Art. XVI, §50(a)(6),(7), and (8).

[8] § 64.054(c).

[9] § 64.001(9). The definition of rents is much broader and includes virtually any payments owed to the assignor relating to owning, operating, improving or leasing of real property as well as proceeds from rental interruption insurance.

[10] § 64.052(a) and (b).

[11] § 64.051(a); S.B. 889 §3(c).

[12] § 64.053(a).

[13] § 64.053(b).

[14] § 64.061(a) and (d).

[15] § 64.060(a).

[16] § 64.060(b).

[17] § 64.055(a). The statute requires that the notice substantially comply with the form prescribed in § 64.056.

[18] § 64.054(3) and (4).

[19] § 64.054(c)(3).

[20] § 64.059(a).

[21] § 64.059(b).

[22] § 64.054(d).

[23] § 64.055(c)(5).

[24] 11 U.S.C. § 541.

[25] 11 U.S.C. § 362.

[26] The lender's interest in rents is protected by bankruptcy law because the borrower must get a bankruptcy court order to use the rents which requires adequate protection for the lender's interest usually in the form of approved budget for expenses to maintain the property. 11 U.S.C. § 363.

[27] § 64.002; §64.001(13); §15.002.

[28] § 64.058.