



NEW LEGISLATION PUTS TEETH INTO ASSIGNMENTS OF RENTS

OVERVIEW

On June 17, 2011, SB 889 became effective to create first-of-its-kind Texas legislation regarding assignments of rents in connection with financing real property. In essence, the bill legislatively validates a significant lender remedy under defaulted real property loans by allowing lenders to collect rents without first foreclosing on the property.

The process to exercise this remedy and collect rents is relatively simple. During a loan default, a secured lender may deliver notices to its borrower and each tenant of the property in the form required by the law, directing that rents thereafter must be delivered to the lender.

Upon the borrower's receipt of the notice, the borrower must deliver to the lender any rent in its possession together with any future rents. When a tenant receives the notice, then, effective shortly after the next rental due date, the tenant must pay directly to the lender all unpaid rents (including operating expenses) and all future rents when payable under the lease (subject to any lease offset rights); provided however, an apartment resident may pay its rent either to the landlord or the lender. A tenant's obligation to pay rent to a lender ceases upon a court order or a lender-signed document cancelling the assignment.

Absent a contrary agreement, all rents collected by the lender will be applied to collection expenses, property protection payments (if the lender has agreed to pay such expenses), loan indebtedness, and subordinate loan indebtedness with any excess being delivered to the borrower. It is important to note that this will not affect any residential homestead property.

HOW WILL THIS NEW LEGISLATION AFFECT SECURED REAL ESTATE LENDERS?

This new legislation enhances the remedies available to secured real property lenders. When a borrower defaults on its loan, a lender now has the right, following issuance of certain statutory notices, to require a borrower and its tenants to send all rent to the lender. This right may be exercised prior to any foreclosure or commencement of foreclosure proceedings. Prior to this legislation, there was very little legal authority which allowed such actions. Because the remedy against a borrower who fails to comply with the assignment notice is a suit against the borrower (which may be of suspect value with a single asset borrower), the benefit of the law may be the ability to force the tenant to deliver rent directly to the lender.

HOW WILL THIS NEW LEGISLATION AFFECT COMMERCIAL REAL ESTATE BORROWERS?

The new legislation is lender-oriented. Borrowers must be aware that this additional tool is available to put more pressure on a borrower in a default scenario. If a borrower fails to deliver rents to the lender following proper notice, the lender may sue the borrower on a personal recourse basis for such amounts (plus the cost of collection), even if the loan was otherwise nonrecourse.

The law also provides that a lender's acceptance of rent does not make it a "mortgagee in possession" or agent of the borrower, constitute an election of remedies or novation of the loan, or limit any other right of the lender, which further limits some of a borrower's common law defenses to loan remedies.

HOW WILL THIS NEW LEGISLATION AFFECT REAL ESTATE TENANTS?

A commercial tenant receiving these notices must be vigilant and promptly change payment procedures to be sure rent is delivered to the lender instead of the borrower. If a commercial tenant does not comply with the assignment notice, the law provides that the tenant's rent obligation is *not* discharged – which means the tenant still owes its rental payment (albeit with the lender facing some practical enforcement challenges). Moreover, with the proliferation of multiple debt tranches, a tenant may be forced to look further into the borrower's debt structure to make sure it is paying rent in accordance with the law.

ARE THERE ISSUES THAT THE LEGISLATION DOES NOT ADDRESS?

How will the bankruptcy courts treat this new legislation? Bankruptcy courts have traditionally disallowed any payment of rents directly to a lender. Bankruptcy practitioners must now develop a payment mechanism with respect to cash collateral orders and provide those orders to each tenant to direct rents to the bankruptcy operating account.

Practically speaking, what process will unfold for a lender to collect the rents for a property and attempt to pay the operating expenses when the lender does not own the property? A lender is generally incentivized to "keep the lights on" to preserve the value of its collateral. But, in instances where the lender does not own the property, there may be a breakdown of communication between the borrower and lender, which will make it difficult for the lender to pay all operating expenses for a property and result in unintended lease defaults.

How will rents that are traditionally bundled with services be treated? In certain areas such as senior housing, fees for non-real estate services are combined with traditional rents. The legislation provides that payments for services are not covered by the law. Thus, there may be a significant practical challenge to the ability to direct these rent payments.

Please contact one of the Thompson & Knight attorneys listed below, or the attorney with whom you usually work, for more information.

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