Ocean Place

Hotel revenues are personal property — not "rents."

On March 31, 2011, Judge Michael B. Kaplan of the United States Bankruptcy Court for the District of New Jersey issued an opinion in *In re Ocean Place Development, LLC*, 2011 Bankr. LEXIS 1097 (Bankr. D.N.J. 2011) that provides a thorough analysis of the treatment of hotel revenues as collateral under Article 9 of the Uniform Commercial Code (UCC) and the Bankruptcy Code.

In so doing, Kaplan addressed whether the Third Circuit's decision in *In re Jason Realty, L.P.*, 59 F.3d 423 (3d Cir. 1995), which held that an assignor's interests in rents under a lease were not property of the assignor's estate, precluded the *Ocean Place* debtor from using its hotel revenue proceeds as part of its reorganization efforts.

Factual Background

On February 15, 2011, Ocean Place Development, LLC ("Ocean Place" or "debtor"), a beachfront resort business, filed a voluntary petition for relief under Chapter 11. The debtor's resort operations centered around its 254-room hotel, which included three restaurants, a full-service spa and numerous resort amenities.

As of the petition date, the debtor owed approximately $57.2 million to its secured creditor, AFP 104 Corp. ("AFP" or "Lender"). AFP's debt was secured by a variety of instruments, including a mortgage, assignment of rents and leases and security agreement, as well as UCC and fixture filings, executed to-

gether with a loan agreement (collectively, "loan documents"). The loan documents defined "rents" as including:

> … all revenues and credit card receipts collected from guest rooms, restaurants, bars, meeting rooms and recreation facilities, all receivables, customer obligations, installment payment obligations and other obligations now existing or hereafter arising or created out of the sale, lease, sublease, license, concession or other grant of the right of the use and occupancy of property or rendering of services by [Ocean Place] or any operator or manager of the hotel or the commercial space located in the improvements or acquired from others … license, lease, sublease, and concession fees and rentals, health club membership fees, food and beverage wholesale and retail sales, service charges, vending machines' sales and process, if any … whether paid or accruing before or after the filing by or against [Ocean Place] of any petition for relief under the Bankruptcy Code.

On February 17, 2011, among other "first day" matters, the court held a hearing on the debtor's motion for an order authorizing the use of cash collateral. That same day, the court entered an interim order authorizing the use of cash collateral.

On March 9, 2011, the court conducted an evidentiary hearing with respect to a final order authorizing the use of cash collateral and AFP's motion to dismiss the debtor's bankruptcy case for cause, including bad faith, because of the debtor's inability to: (i) successfully reorganize; and (2) provide AFP with adequate protection. Central to AFP's position was its argument that the "hotel revenues" (or "rents" under the loan documents) were not part of the debtor's estate because they were unconditionally and absolutely assigned to AFP prior to the bankruptcy filing.

On March 10, 2011, the court denied AFP's cross motions for dismissal or stay relief, and granted the debtor's motion for a final order approving the use of cash collateral. The court recited its decision regarding the motions into the record and stated its intent to file a more expansive written opinion on certain issues. Thereafter, the court issued its written decision addressing the characterization of the hotel room revenues collected by Ocean Place and its analysis of the applicability of *Jason Realty*.

"There are limitations to Article 9 because it does not extend to 'the creation or transfer of any interest in or lien on real property, including a lease or rents thereunder.'"

Analysis

The court began its analysis by reciting the broad scope of the bankruptcy estate under 11 U.S.C. § 541; specifically, its inclusion of proceeds, rents or profits of or from property of the estate.[1]

The court explained that Ocean Place sought permission to use AFP's "cash collateral," which by definition includes "cash … and … proceeds, products, offspring, rents or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels or other lodging properties subject to a security interest …." 11 U.S.C. § 363(a).[2]

Against this backdrop, the court turned to the treatment of hotel room revenues under UCC Article 9. By its provisions, Article 9 applies to a transaction that creates a security interest in personal property or fixtures.[3] However, there are limitations to Article 9 because it does not extend to "the creation or transfer of any interest in or lien on real property, including a lease or rents thereunder."[4]

In viewing the financing transaction in *Ocean Place*, Kaplan found that it was a secured transaction reflected by the terms of the loan documents, including that: (i) AFP was granted a security interest in the rents; (ii) the assignment of rents stated that it was a "security agreement within the meaning of the UCC"; and (iii) the debtor was permitted to collect rents so long as the debtor was not in default.[5]

As for the Article 9 exception relating to real property and leases/rents thereunder, the *Ocean Place* court found the exception inapplicable to hotel room revenues

[1] *In re Ocean Place Development*, LLC, 2011 Bankr. LEXIS 1097, *8 (Bankr. D.N.J. March 31, 2011).
[2] *Id.* at *9-10.
[3] UCC § 9-109(a).
[4] UCC § 9-109(d)(ii).
[5] *Id.* at *12-13.
[6] *Id.* at *13-15 (citing *In re Kearney Hotel Partners v. Richardson*, 92 B.R. 95 (Bankr. S.D.N.Y. 1988); *In re Northview Corp.*, 130 B.R. 543 (9th Cir. BAP 1991).
[7] *Id.* at *16-18.
[8] *Id.* at *19.

because: (i) hotel room revenues are "accounts" or "payments intangible" under Article 9; and (ii) hotel occupants are not "tenants" who possess an interest in real property, but are merely licensees.[6]

While Kaplan acknowledged the loan documents' expansive definition of "rents," he found that the official comments to the UCC stressed the importance of substance over form; consequently, labels given by the parties did not control.[7] In assessing the "substance" of the transaction, the court also noted that AFP's UCC-1 filings reinforced that AFP understood its security interest in the revenues to be governed by the UCC.[8]

Finally, Kaplan illuminated various New Jersey statutes and state court decisions that recognize a distinction between a guest in a hotel and a tenant under a lease.[9] For example, the Truth-In-Renting Act, *N.J.S.A.* 46:8-43, *et seq.* — the purpose of which is to set forth the rights and responsibilities of residential tenants and landlords in New Jersey — specifically excludes from the application of the act "dwelling units … in hotels, motels, or other guest houses serving transient or seasonal guests."

Similarly, New Jersey courts have drawn distinctions based upon the right of "exclusive possession"; specifically, "[w]hile the tenant has exclusive legal possession of the premises, the lodger only has the right to use the premises, subject to the landlord's retention of control and right to access of them."[10] Thus, the *Ocean Place* court found that New Jersey statutes and New Jersey case law support the finding that interests in hotel room revenues and interests in real property under a lease should be treated differently.[11] Consistent with those findings, Kaplan concluded that the hotel revenues were personal property in which AFP held a perfected security interest and were properly considered property of the debtor's estate.[12]

The court then turned its attention to the Third Circuit's seminal case of *Jason Realty* to assess whether that case precludes a finding that the interests in the debtor's hotel room revenues are interests in personal property, and thus property of the estate available to the debtor in its reorganization efforts. In *Jason Realty*, the debtor had executed, pre-petition, an absolute assignment of certain leases and rents.

Upon noting that "assignments of rents are interests in real property," the issue before the Third Circuit was "whether the assigned rents should have been classified as property of the estate."[13] The Third Circuit held that the debtor no longer retained an interest in the rents and the rents were not property of the estate.

Kaplan distinguished *Jason Realty* on several grounds. First, *Jason Realty* did not involve a debtor's assignment of receipts from non-leasehold interests, such as receipts realized from a debtor's operation of a hotel, restaurant or spa. Second, the Third Circuit in *Jason Realty* was presented with a different task; specifically, the Third Circuit was to determine whether the assignment of an undeniable interest in real property conveyed title to the lender or, instead, pledged the rents, whereas the *Ocean Place* court was "tasked with determining whether hotel room revenues should be treated as interests in real property."[14]

The *Ocean Place* court held that "the Third Circuit [in *Jason Realty*] did not intend to include non-leasehold interests within the purview of its decision"; consequently, *Jason Realty* did not control "because the revenues at issue [were] interests in personal property, not real property."[15] Kaplan further found that "[t]o rule otherwise would countenance the ability of lenders to take security interests in personal property in a manner to evade protections afforded to obligors under Article 9."[16]

Conclusion

In the Third Circuit, any prospective Chapter 11 debtor engaged in a real estate-related business needs to be aware of *Jason Realty* because, if applicable, it can take away the lifeline (cash/rents) of the Chapter 11 debtor.

As shown by the *Ocean Place* decision, *Jason Realty* does not necessarily apply to all real estate-related businesses and lending arrangements. Indeed, as found by Kaplan, *Jason Realty* is inapplicable when dealing with non-leasehold interests, such as hotel revenues. Going forward, it will be interesting to see if *Ocean Place* spawns more Third Circuit Chapter 11 debtors contending that their "rents" arise from non-leasehold interests. ●

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[9] *Id.* at *20-24
[10] *Id.* at *21-22 (quoting *Johnson v. Kolibas*, 75 N.J. Super. 56, 182 A.2d 157 (App. Div. 1962), *certif. den.* 38 N.J. 310, 184 A.2d 422 (1962)).
[11] *Id.* at *23.
[12] *Id.* at *24.
[13] *Id.* at *25 (quoting *Jason Realty*, 59 F.3d at 426).
[14] *Id.* at *29.
[15] *Id.* at *32-33.
[16] *Id.* at *33; *see also id.* at *20 (citing redemption rights (UCC § 9-623) and collateral disposition requirements (UCC § 9-610)).