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## Of Hotel Revenues, Rents, and Formalism in the Bankruptcy Courts: Implications for Reforming Commercial Real Estate Finance

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**OF HOTEL REVENUES, RENTS, AND  
FORMALISM IN THE BANKRUPTCY  
COURTS: IMPLICATIONS FOR  
REFORMING COMMERCIAL  
REAL ESTATE FINANCE**

R. Wilson Freyermuth\*

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#### INTRODUCTION

When the owner of a development files for bankruptcy and becomes a debtor-in-possession,<sup>1</sup> a battle erupts over the revenues the

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1. The primary objective of most developers in filing bankruptcy is to avoid pending or threatened state law remedies sought by the mortgagee, such as foreclosure or receivership. By filing for bankruptcy protection under Chapter 11, the owner of a development becomes a "debtor-in-possession" under 11 U.S.C. § 1101(1) (1988), and is thus entitled to possession of the development and control over its day-to-day opera-

development generates after the bankruptcy filing ("postpetition revenues"). The debtor-in-possession—typically a partnership or corporate entity that has no assets other than the development—often wants to use these revenues to fund its reorganization efforts and pay professional fees and expenses.<sup>2</sup> In contrast, the mortgagee, to whom the developer granted a lien on the revenues, wants to prevent the debtor's use of those revenues, which the mortgagee claims as its "cash collateral" under section 363 of the Bankruptcy Code.<sup>3</sup>

To resolve this dispute, a bankruptcy court must categorize those revenues as a particular type of collateral. If the development is an apartment complex, for example, the bankruptcy courts usually characterize the revenues as "rents." The bankruptcy court then must ask (a) whether the mortgagee obtained a perfected prepetition security interest in that type of collateral and (b) whether that perfected security interest attaches to the postpetition revenues. Generally, section 552(a) of the Bankruptcy Code provides that property received by a debtor postpetition is not subject to any prebankruptcy security agreement.<sup>4</sup> If section 552(a) applied to the development, a mortgagee with a lien upon the rents would lose its lien upon postpetition rents. Section 552(b) provides protection for the commercial mortgagee, however, by allowing the mortgagee to maintain its lien against the postpetition "proceeds," "rents," or "profits" of the development to the extent provided by the mortgage and applicable law.<sup>5</sup> Thus, if the mortgagee has a valid and properly perfected prepetition lien upon the development and its rents, section 552(b) permits the mortgagee to retain its lien against the postpetition rents.

Enterprising developers and their creative attorneys, however, have used the provisions of the Bankruptcy Code and uncertainties

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tions. *Id.* § 541 (development constitutes property of the estate); § 1107(a) (debtor-in-possession entitled to general powers of trustee, including possession of property of estate); § 1108 (debtor-in-possession entitled to operate business).

2. *See, e.g.*, Robert A. Silverman & Bruce Grohsgal, *Critical Issues in Single-Asset Real Estate Bankruptcies*, *REAL EST. REV.*, Summer 1992, at 30, 31.

3. Section 363(a) defines "cash collateral" to include "cash . . . or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, . . . rents, or profits of property subject to a security interest . . ." 11 U.S.C. § 363(a) (1988). The debtor-in-possession may not use a creditor's cash collateral unless that creditor consents or unless the court authorizes that use following notice and a hearing. *Id.* § 363(c)(2).

4. *Id.* § 552(a).

5. *Id.* § 552(b).

in state real property laws to avoid the effect of section 552(b).<sup>6</sup> The focus on this article is one such uncertainty—the treatment of a hotel mortgagee's lien upon hotel room revenues. In many commercial land developments—such as shopping centers, office buildings, or apartment complexes—the developer and the occupier stand in a relationship of landlord and tenant in which the tenant clearly pays “rent.” Bankruptcy courts administering distressed projects of this type uniformly have held that if a mortgagee possesses a validly perfected prepetition lien against the “rents” of such a development, then the mortgagee's lien falls within the protections of section 552(b).<sup>7</sup>

In many other developments, however, the developer and the occupier do not stand in the relationship of landlord and tenant. In some commercial land developments, the occupier might be only a licensee. Examples of this type of project include nursing homes,<sup>8</sup> parking garages,<sup>9</sup> golf courses,<sup>10</sup> and student dormitories,<sup>11</sup> but by

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6. One such uncertainty, which is not the primary focus of this Article but is discussed briefly *infra* note 265, concerns what action is necessary for a mortgagee to have a perfected security interest in rents. Under the Supreme Court's landmark decision in *Butner v. United States*, 440 U.S. 48 (1979), state law determines the extent to which a secured creditor's lien upon rents is enforceable in bankruptcy. The primacy of state real estate laws, which may vary significantly from state to state, has generated conflict in the bankruptcy courts as to when a mortgagee's security interest in rents is “perfected.” Some courts have concluded that certain states' laws permit a mortgagee to perfect its lien upon rents by duly recording its assignment of rents on the real estate records. *See, e.g., In re Raleigh/Spring Forest Apartments Assocs.*, 118 B.R. 42, 44–45 (Bankr. E.D.N.C. 1990) (security interest in rents perfected upon recording of assignment of rents); *In re Metro Square*, 106 B.R. 584, 587 (Bankr. D. Minn. 1989) (same). Other courts have concluded that the relevant state law requires a mortgagee to take actual or constructive possession of the realty following default in order to perfect its lien upon rents. *See, e.g., In re Village Properties, Ltd.*, 723 F.2d 441, 443–47 (5th Cir. 1984) (security interest in rents unperfected where mortgagee had not obtained possession of property, impounded rents, or secured appointment of receiver); *In re Prichard Plaza Assocs. Ltd. Partnership*, 84 B.R. 289, 293–97 (Bankr. D. Mass. 1988) (same); *see also* Craig H. Averch, *The Heartbreak Hotel for Secured Lenders: When Postpetition Revenue from a Hotel Is Not Subject to a Prepetition Security Interest*, 107 BANKING L.J. 484, 485 n.3 (1990) (collecting cases). As discussed *infra* Part III, this nonuniformity in the treatment of identical transactions is not justifiable in terms of sound commercial policy.

7. *See, e.g., In re Metro Square*, 106 B.R. 584, 587 (Bankr. D. Minn. 1989).

8. *See In re Hillside Assocs. Ltd. Partnership*, 121 B.R. 23 (Bankr. 9th Cir. 1990) (nursing home residents are licensees); *In re Woodstock Assocs. I, Inc.*, 120 B.R. 436 (Bankr. N.D. Ill. 1990) (same).

9. *See, e.g., In re Ashford Apartments Ltd. Partnership*, 132 B.R. 217 (Bankr. D. Mass. 1991) (parking garage users called licensees).

10. *See, e.g., In re GGVXX, Ltd.*, 130 B.R. 322 (Bankr. D. Colo. 1991) (golfers characterized as licensees).

11. *See, e.g., Cook v. University Plaza*, 427 N.E.2d 405 (Ill. App. Ct. 1981) (residents of privately-owned student dorm not “tenants” but “licensees”).

far the most common is the hotel. Most bankruptcy courts administering distressed hotels have held that a mortgagee's lien upon room revenues does not survive the filing of a bankruptcy petition. According to these courts, because there is no landlord-tenant relationship between the developer and the guests, the sums paid by the guests cannot constitute "rents" of the hotel.<sup>12</sup> When the developer files its bankruptcy petition, therefore, section 552(b) does not protect the mortgagee's lien upon room revenues, *even if that lien was validly perfected under state law prior to bankruptcy*. As a result, the mortgagee's lien becomes inoperative against postpetition room revenues under section 552(a).

Regrettably, these hotel bankruptcy decisions do not thoughtfully address the nature of the income generated by a commercial real estate development. Is there any relevant difference between the income produced by a hotel and that generated by an apartment complex? In today's modern commercial environment, should the sanctity of the mortgagee's lien upon that income depend upon whether it is paid by a tenant as opposed to a licensee? Fortunately, the American Law Institute, in the proposed *Restatement (Third) of Property—Security (Mortgages)*, has now focused some thoughtful attention upon these questions. In *Tentative Draft No. 2* of the proposed *Restatement*, the drafters define "rents" as "the proceeds payable by a lessee, licensee, or other person for the right to possess, use, or occupy the real property of another."<sup>13</sup> Pursuant to this suggested reform, hotel room revenues, parking fees and all other sums paid in exchange for the temporary right to use, occupy, or possess the land of another would be treated as "rents" in the nature of realty.<sup>14</sup>

This Article is intended to continue the dialogue begun by the proposed *Restatement* and has two distinct goals in this effort. Parts I through III argue that the position of the *Restatement* drafters is both legally and functionally sound and that bankruptcy courts should embrace and apply the proposed *Restatement* in administering distressed real estate developments. Part I reviews the reasoning articulated in the hotel bankruptcy cases, demonstrating how courts have applied the provisions of the Bankruptcy Code and state law in a formalistic manner to extinguish the hotel mortga-

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12. See *infra* notes 23–33 and accompanying text.

13. RESTATEMENT (THIRD) OF PROPERTY-SECURITY (MORTGAGES) § 4.2(a) (Tentative Draft No. 2, 1992) [hereinafter RESTATEMENT (THIRD)].

14. *Id.* illus. 7 (hotel room revenues); *id.* illus. 9 (parking lot revenues).

gee's lien upon postpetition room revenues.<sup>15</sup> Part II rejects the analysis of the hotel bankruptcy cases on legal grounds. Although the drafters of the proposed *Restatement* appear to base their recommendations purely upon the functional similarity of rents and hotel room revenues,<sup>16</sup> bankruptcy courts properly may characterize hotel room revenues as "rent" in the nature of real property. The notion that a licensee may pay "rent" in exchange for its constituent rights respecting the land is consistent with the original common law scope of the term "rent," as well as the nature and scope of the term within the civil law tradition.<sup>17</sup> Part III then criticizes the hotel bankruptcy cases on policy grounds, demonstrating that financial and economic realities do not justify distinguishing between real estate projects based solely upon the status of the occupier as a tenant rather than a licensee. To the developer and the mortgagee, the occupancy revenues generated by the apartment and the hotel are economically identical. Accordingly, sound commercial policy dictates that security law should treat hotel mortgagees with liens upon hotel room revenues no differently than apartment mortgagees holding liens upon rents.<sup>18</sup>

In Part IV, this Article shifts away from the hotel bankruptcy cases to focus on broader questions that the proposed *Restatement* and bankruptcy court jurisprudence have not addressed. What is the true nature of the income paid in exchange for the right to occupy real estate? What consequences follow for the manner in which parties document commercial real estate transactions and bankruptcy courts administer distressed developments? Part IV begins by questioning whether the term "rent" (with its attendant common law baggage) continues to be a useful concept for describing the revenue produced by the modern commercial land development. Bankruptcy courts and orthodox real estate finance law characterize real estate income as either "rent" (in the nature of realty) or "nonrent" (in the nature of personalty) depending upon whether the income was paid for the use of land or for the provision of services.<sup>19</sup> This historical distinction has diminished meaning and validity when applied to the occupier of the modern commercial land development, who contracts not for the bare use of land,

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15. See *infra* notes 23–57 and accompanying text.

16. RESTATEMENT (THIRD), *supra* note 13, § 4.2 reporter's note.

17. See *infra* notes 58–148 and accompanying text.

18. See *infra* notes 149–186 and accompanying text.

19. See *infra* note 205 and accompanying text.

but for an inseparable mix of space and services that together constitute a developer's "product."<sup>20</sup>

Part IV suggests that property security law should not continue to treat sums paid by commercial occupants as "rent" in the nature of realty, but should instead employ different conceptual paradigms. In reality, the modern commercial real estate development is a depreciating capital asset with a finite productive capacity and a limited useful economic life. Its value is a function of the revenues that it can generate over its economic life. Sums paid by occupiers during that useful life constitute the proceeds of the development's economic value, as that value is consumed over time. Thus, security law should treat these sums as "proceeds" of the development, so that a lien upon such sums would be protected in bankruptcy under section 552(b).<sup>21</sup> Furthermore, the developer's consumption of the development's economic value over time is not different in substance from an outright sale of the development. As Part IV argues, it is inconsistent to treat a mortgagee's interest in "rent" as real estate collateral while treating an installment land contract vendor's interest in contract payments as personalty. Instead, Part IV suggests that all income generated pursuant to contracts in which one party purchases an interest in land from another should be treated as personalty when pledged as security, with liens upon such income being governed by Article 9 of the Uniform Commercial Code.<sup>22</sup>

## I. CONVENTIONAL WISDOM IN THE BANKRUPTCY COURTS AND THE TREATMENT OF SECURITY INTERESTS IN HOTEL ROOM REVENUES

### A. *The Nature of the Guest's Interest and Obligation*

In introducing their first-year students to the subject of landlord and tenant, Professors Edward Rabin and Roberta Kwall provide the following caveat:

Lease or license? A license, unlike a lease, is not a possessory interest in land. A license merely authorizes the licensee to use land in the possession of another. The license arises from the consent of the owner of the possessory interest. Since different rules govern licenses and leases, it is often necessary to distinguish between them. . . . One should resist the temptation to

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20. See *infra* notes 192–219 and accompanying text.

21. See *infra* notes 220–250 and accompanying text.

22. See *infra* notes 251–267 and accompanying text.



approach such questions from too high a level of abstraction. The practical context in which the question of lease or license is raised must never be overlooked. A court will be reluctant to find that a particular arrangement is a "license" if this will create an injustice or thwart an important public policy. *In fact, one may question whether any controversy should ever be decided merely by classifying the interest involved as a lease or a license.*<sup>23</sup>

One suspects that the students of Professors Rabin and Kwall, desperate to accord a single understanding to each new concept (as first-year students often are), probably fail to understand the larger message underlying this caveat—one should never decide how to allocate property rights between parties to a dispute without considering the context in which the dispute arises.

Unfortunately, bankruptcy courts faced with resolving the debtor/mortgagee dispute over postpetition hotel room revenues also seem to have forgotten this message. In hotel bankruptcy cases, the courts have chosen to classify hotel room revenues based on the legal relationship between the hotel owner and its guests. A hotel, of course, typically does not involve "real estate leases," that is, conveyances that create a nonfreehold estate. A hotel guest instead receives a mere contractual right to occupy her assigned room, which courts typically have classified as a license.<sup>24</sup> If the owner or a third party wrongfully interferes with the guest's right to occupy that room, the guest's remedy is for contract damages; the guest has no legal remedy that entitles her to recover occupation of the room, unlike the tenant, who may recover possession of the demised premises.<sup>25</sup>

In theory, this distinction between the remedies of the tenant and the hotel guest merely clarifies their respective positions vis-à-vis the owner of the premises. This distinction has no necessary consequence in characterizing the nature of their respective obligations. Nevertheless, the vast majority of bankruptcy courts have relied upon this distinction to conclude that a hotel mortgagee has

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23. EDWARD H. RABIN & ROBERTA R. K WALL, FUNDAMENTALS OF MODERN REAL PROPERTY LAW 26-27 (3d ed. 1992) (emphasis added).

24. See, e.g., NATHAN KALT, LEGAL ASPECTS OF HOTEL, MOTEL, AND RESTAURANT OPERATION 28-31 (1971); HENDRIK ZWARENSTEYN, FUNDAMENTALS OF HOTEL LAW 50 (1963).

25. See, e.g., *In re Greater Atl. & Pac. Inv. Group*, 88 B.R. 356, 359 (Bankr. N.D. Okla. 1988) ("As a general rule . . . 'guests in a hotel . . . are mere licensees and not tenants, and . . . they have only a personal contract and acquire no interest in the realty . . . the relation is not that of landlord and tenant, for, notwithstanding the guest's occupancy, it is the house of the innkeeper.'") (quoting 49 AM. JUR. 2D *Landlord & Tenant* § 6 (1970)).

no lien upon room revenues because those revenues are not “rents” in the nature of real property.<sup>26</sup> The decision of the United States Bankruptcy Court for the District of Minnesota in *In re Mid-City Hotel Associates*<sup>27</sup> typifies the analysis of these courts. The mortgagee in *Mid-City*, Prudential Insurance Company of America (“Prudential”), obtained and recorded an assignment of rents, issues, profits and revenues from the debtor Mid-City Hotel Associates, which owned and operated the Minneapolis Metrodome Hilton. Following its bankruptcy filing, the debtor sued Prudential, arguing that the assignment of rents, issues, profits and revenues did not create an enforceable lien against room revenues. The debtor argued that room revenues do not constitute “rents,” because “‘rents’ must be restricted to income arising out of a landlord-tenant relationship—that relationship based on a tenancy of real estate for a fixed term, and those funds paid in consideration for the exclusive use and occupancy of such real estate.”<sup>28</sup>

The *Mid-City* court began its analysis by contrasting a hotel guest, who “holds nothing more than a license to enter on the hotel premises,” with a tenant, who “holds a legally-cognizable interest in

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26. See, e.g., *In re Northview Corp.*, 130 B.R. 543, 546–48 (Bankr. 9th Cir. 1991); *In re General Associated Investors Ltd. Partnership*, 150 B.R. 756, 759–62 (Bankr. D. Ariz. 1993); *In re Thunderbird Inn, Inc.*, 151 B.R. 224, 226–27 (Bankr. D. Ariz. 1993); *In re T-H New Orleans Ltd. Partnership*, 148 B.R. 456, 459–63 (E.D. La. 1992); *Financial Sec. Assurance, Inc. v. Days Cal. Riverside Ltd. Partnership*, No. S-92-119GEB, 1992 WL 471706, at \*2-4 (E.D. Cal. Aug. 18, 1992); *In re Tri-Growth Centre City, Ltd.*, 133 B.R. 524, 526 (Bankr. S.D. Cal. 1991); *In re Corpus Christi Hotel Partners*, 133 B.R. 850, 854 (Bankr. S.D. Tex. 1991); *In re Nendels-Medford Joint Venture*, 127 B.R. 658, 663–68 (Bankr. D. Or. 1991); *In re Majestic Motel Assocs.*, 131 B.R. 523, 526 (Bankr. D. Me. 1991); *In re Shore Haven Motor Inn, Inc.*, 124 B.R. 617, 618 (Bankr. S.D. Fla. 1991); *In re Airport Inn Assocs., Ltd.*, 132 B.R. 951, 954 (Bankr. D. Colo. 1990); *In re Sacramento Mansion, Ltd.*, 117 B.R. 592, 606 (Bankr. D. Colo. 1990); *In re Oceanview/Virginia Beach Real Estate Assocs.*, 116 B.R. 57, 58–59 (Bankr. E.D. Va. 1990); *In re M. Vickers, Ltd.*, 111 B.R. 332, 335–37 (Bankr. D. Colo. 1990); *In re Investment Hotel Properties*, 109 B.R. 990, 993–94 (Bankr. D. Colo. 1990); *In re Kearney Hotel Partners*, 92 B.R. 95, 98–102 (Bankr. S.D.N.Y. 1988); *In re Greater Atl. & Pac. Inv. Group*, 88 B.R. 356, 359 (Bankr. N.D. Okla. 1988); *In re Ashkenazy Enters.*, 94 B.R. 645, 646–47 (Bankr. C.D. Cal. 1986); *United States v. PS Hotel Corp.*, 404 F. Supp. 1188, 1191–92 (E.D. Mo. 1975). But see *In re S.F. Drake Hotel Assocs.*, 131 B.R. 156, 158–61 (Bankr. N.D. Cal. 1991) (hotel room revenues are rents), *aff’d*, 147 B.R. 538 (N.D. Cal. 1992); see also *In re Mid-City Hotel Assocs.*, 114 B.R. 634, 638–42 (Bankr. D. Minn. 1990) (hotel room revenues are not rents but are profits in nature of realty).

27. 114 B.R. 634 (Bankr. D. Minn. 1990).

28. *Id.* at 638.

the real estate itself."<sup>29</sup> The court then noted that "a tenant pays 'rents' in consideration for his use and occupancy of real estate."<sup>30</sup> From these premises, the court concluded:

By negative inference if nothing else, then, a hotel guest does not pay "rent." Rather, the guest pays a room rate to the host in consideration for a license to enter and make temporary use of a portion of the host's real estate for a limited time, and for a limited purpose.

Room rates, thus, cannot be legally categorized as "rents."<sup>31</sup>

According to other courts that have adhered to this reasoning, hotel room revenues are not "rents," but instead constitute personal property in the nature of "accounts,"<sup>32</sup> such that a mortgagee's lien upon room revenues is governed not by real estate law but by Article 9 of the Uniform Commercial Code ("UCC").<sup>33</sup> By classifying hotel room revenues in this fashion, bankruptcy courts have effectively extinguished the hotel mortgagee's bargained-for lien upon room revenues through one of two statutory traps—either UCC section 9-104(j) or Bankruptcy Code section 552(a).

#### B. *The UCC Section 9-104(j) Trap*

Article 9 of the UCC governs only those transactions intended to create security interests in personalty.<sup>34</sup> Consistent with this purpose, section 9-104(j) excludes from Article 9's scope any transaction intended to create a security interest in real estate, such as a real property lease or rents.<sup>35</sup> For example, in the typical commercial mortgage transaction for an apartment complex, the owner pledges both the complex and its leases and rents as security for the

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29. *Id.* at 640-41 (citations omitted). Of course, one can also characterize a hotel guest's license as a legally cognizable interest in land. See *infra* notes 130-147 and accompanying text.

30. 114 B.R. at 641.

31. *Id.*

32. The UCC defines "account" as "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper, whether or not it has been earned by performance." U.C.C. § 9-106 (1987). As discussed in Part IV of this Article, many bankruptcy courts have concluded that "hotel revenues constitute service income, rather than income generated by the real property collateral; therefore, the 'services' and not the realty create the accounts . . ." Averch, *supra* note 6, at 490 (discussing rationale of hotel bankruptcy decisions).

33. As discussed in Part III.C *infra*, the *Mid-City Hotel* court held that even though hotel revenues were not "rents," they did constitute "profits" of the hotel and were thus interests in land subject to Prudential's lien. *Mid-City Hotel*, 114 B.R. at 641-42.

34. See U.C.C. § 9-102(1) (1987).

35. *Id.* § 9-104(j).

mortgage debt. Since section 9-104(j) excludes these security interests from Article 9, the mortgagee's lien against the rents is governed by real estate law.

In the typical hotel mortgage transaction, the developer also pledges both the hotel and its revenues as security.<sup>36</sup> In many "old" hotel mortgage transactions (those documented seven to ten years ago or longer), many developers and mortgagees apparently assumed that because room revenues were generated by the temporary occupation of real estate, they were "rent" in the nature of realty.<sup>37</sup> Based upon this assumption, many such hotels were financed with documents entitled "Assignments of Rents," which effectively granted security interests in "rents," "issues," and "profits," but not an Article 9 security interest in accounts.

Bankruptcy courts analyzing such hotel financing transactions have concluded with near unanimity that since room revenues are not "rents," the mortgagee has no security interest in the room revenues.<sup>38</sup> The decision of the United States Bankruptcy Court for the Northern District of Oklahoma in *In re Greater Atlantic and*

36. See Averch, *supra* note 6, at 484 ("The loan amount funded by a lender secured by income-producing real properties . . . is generally calculated on the projected revenue generated from the property. Therefore a lien on the revenue generated from an income-producing property is vital to properly collateralize a loan on such real property.") (footnotes omitted); see also *In re S.F. Drake Hotel Assocs.*, 131 B.R. 156, 160 (Bankr. N.D. Cal. 1991) ("Hotel room revenues are, or resemble, rents in that they are a primary component used by appraisers in valuing a hotel. The value of the income stream, rents, is a major factor in determining the value of the real property. The income is what the debtor and the secured lender look to for payment of the loan.").

37. See, e.g., Ricardo R. Calderon, *The Significance and Implications of the Rents Versus Accounts Receivable Debate in Hotel Bankruptcies*, 21 REAL EST. L.J. 136, 138 (1992) ("Until recently, the ability of a lender to insure its right to the stream of income [generated by a hotel] during the pendency of a bankruptcy had been thought achievable by virtue of the execution and proper recordation of an assignment of leases and rents and a mortgage.").

38. See, e.g., *In re General Associated Investors Ltd. Partnership*, 150 B.R. 756, 759-62 (Bankr. D. Ariz. 1993); *In re Tri-Growth Centre City, Ltd.*, 133 B.R. 524, 526 (Bankr. S.D. Cal. 1991); *In re Majestic Motel Assocs.*, 131 B.R. 523, 526 (Bankr. D. Me. 1991); *In re Shore Haven Motor Inn, Inc.*, 124 B.R. 617, 618 (Bankr. S.D. Fla. 1991); *In re Oceanview/Virginia Beach Real Estate Assocs.*, 116 B.R. 57, 58-59 (Bankr. E.D. Va. 1990); *In re M. Vickers, Ltd.*, 111 B.R. 332, 335-37 (Bankr. D. Colo. 1990); *In re Greater Atl. & Pac. Inv. Group*, 88 B.R. 356, 359 (Bankr. N.D. Okla. 1988); *In re Ashkenazy Enters.*, 94 B.R. 645, 646-47 (Bankr. C.D. Cal. 1986); see also *In re Anderson*, 137 B.R. 819, 821 (Bankr. D. Colo. 1992) (revenues generated by feedlot operation analogous to hotel revenues, do not constitute "rent").

According to these bankruptcy courts, the hotel mortgagee can provide itself "protection" versus hotel room revenues by obtaining and perfecting an Article 9 security interest in accounts receivable. As discussed *infra* notes 44-57 and accompanying text, however, these same bankruptcy courts have concluded that this "protection" becomes meaningless once the hotel owner files for bankruptcy, since at that time Bankruptcy

*Pacific Investment Group, Inc.*<sup>39</sup> is typical of these cases. The debtor in that case owned a Holiday Inn in Branson, Missouri, upon which it had granted a mortgage and an assignment of all "rents, issues and profits" of the hotel.<sup>40</sup> The mortgagee sued to prevent the trustee from using room revenues. The court, however, allowed the trustee to operate the hotel under a stipulated order that permitted the trustee to use "postpetition rents receivable."<sup>41</sup> The trustee operated under this order for eighteen months, generating a surplus of net operating revenues upon which the mortgagee claimed a lien.<sup>42</sup> Despite the terminology of the earlier stipulated order, however, the court held that the mortgagee never had any lien upon room revenues, because the room revenues were not "rents" but "accounts" which were not described in the mortgagee's loan documents.<sup>43</sup>

### C. *The Bankruptcy Code Section 552(a) Trap*

One might argue that hotel mortgagees who run afoul of UCC section 9-104(j) suffer the consequences of their own omissions. Why stretch to protect a hotel mortgagee that could have protected itself by obtaining and properly perfecting a security interest in accounts under Article 9? The answer is that simple compliance with Article 9 does not cure the mortgagee's problem. According to the

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Code § 552(a) effectively extinguishes the hotel mortgagee's lien against postpetition room revenues.

39. 88 B.R. 356 (Bankr. N.D. Okla. 1988).

40. *Id.* at 357-58.

41. *Id.* at 358. The order further provided that the mortgagee's lien against "postpetition rents receivable" would be valid to the same extent as its lien against "prepetition rents receivable." *Id.*

42. *Id.*

43. *Id.* at 359-60. In other hotel cases, the mortgagees' loan documents did describe accounts as collateral, but the mortgagees (perhaps assuming room revenues were rents in the nature of realty) failed to file financing statements in the central UCC records. One example is the unfortunate purchase-money seller of a Kearney, Nebraska Holiday Inn in *In re Kearney Hotel Partners*, 92 B.R. 95 (Bankr. S.D.N.Y. 1988). The seller's deed of trust included as collateral all fixtures, rents, proceeds, and revenue of any nature derived from the hotel. *Id.* at 96. While the seller recorded notice of its liens in the realty records, it did not file UCC financing statements with the Nebraska Secretary of State. *Id.* at 97. During bankruptcy, the debtor's operations generated \$2.8 million of postpetition room revenues. The debtor sought to avoid the seller's claimed lien against this sum, contending that the seller's lien was unperfected and thus avoidable under Bankruptcy Code § 544(a) (which accords debtors-in-possession the status of a hypothetical judicial lien creditor, who would prevail over unperfected security interests under UCC § 9-301(1)(b)). The court agreed, concluding that the \$2.8 million was not "rent" but "accounts" in which the seller had an unperfected security interest avoidable in bankruptcy. *Id.* at 98-103; see also *In re Punta Gorda Assocs.*, 137 B.R. 535, 537 (Bankr. M.D. Fla. 1992).

majority of bankruptcy courts that have considered the question, Bankruptcy Code section 552(a) will effectively extinguish a hotel mortgagee's validly perfected prepetition security interest in accounts.

Section 552(a) provides that a prepetition security agreement does not affect property that a debtor's estate acquires postpetition.<sup>44</sup> This section prevents a secured creditor's prepetition floating lien from attaching to property acquired postpetition. A secured party holds a floating lien when it holds a security interest in all of a particular type of collateral owned by a debtor, whether owned now or acquired in the future. For example, if First Bank holds a floating lien upon XYZ Co.'s "equipment," it has a security interest in all equipment currently owned by XYZ Co. and any equipment that XYZ Co. acquires in the future. Outside of bankruptcy, there is no question that First Bank's floating lien is valid and enforceable.<sup>45</sup> Once XYZ Co. files for bankruptcy, however, section 552(a) terminates the prospective impact of First Bank's floating lien. If XYZ Co. acquires ten new machines after bankruptcy, First Bank's security interest will not attach to those machines.

Despite its harsh consequences for secured creditors like First Bank, section 552(a) is necessary and appropriate to implement the Code's broad policy goal of assisting debtors to rehabilitate themselves.<sup>46</sup> Section 552(a)'s impact upon the creditor's lien, however, is only prospective. Section 552(a) does not affect the validity of the creditor's lien against prepetition collateral. If First Bank had a valid and properly perfected prepetition lien upon XYZ Co.'s equipment, then First Bank continues to retain its lien upon all equipment owned by XYZ Co. prepetition.

But suppose that XYZ Co. sells or leases two pieces of prepetition collateral after the petition date. Does the creditor's lien attach to the proceeds of the sales or the rental income collected by XYZ Co.? To clarify that section 552(a) is not intended to affect the creditor's lien against such funds, Congress added section 552(b):

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44. 11 U.S.C. § 552(a) (1988).

45. U.C.C. § 9-204(1) (1987) ("[A] security agreement may provide that any or all obligations covered by the security agreement are to be secured by after-acquired collateral.").

46. If postpetition property is not subject to a prepetition security agreement, then the debtor can use property acquired postpetition to secure the financing necessary to assist in an orderly rehabilitation. See, e.g., *In re Photo Promotion Assocs.*, 53 B.R. 759, 763 (Bankr. S.D.N.Y. 1985); *In re Lawrence*, 41 B.R. 36, 37 (Bankr. D. Minn. 1984).

[I]f the debtor and [the secured party] entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to *proceeds, product, offspring, rents, or profits of such property*, then such security interest extends to such proceeds, product, offspring, rents, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law . . . .<sup>47</sup>

Under section 552(b), if the debtor sells or leases prepetition collateral, and the security agreement gives the secured party a lien upon the proceeds, rents, or profits of the collateral, the secured party's lien attaches to any proceeds, rents, or profits that the debtor receives postpetition.<sup>48</sup> This provision affords critical protection for the mortgagee of a typical apartment complex; under section 552(b), a mortgagee with a valid and enforceable prepetition lien upon the complex and its rents also has a lien against postpetition rents if the owner files for bankruptcy. Because those postpetition rents will constitute the mortgagee's cash collateral, the debtor will be unable to use them unless the debtor can adequately protect the mortgagee's interest.<sup>49</sup>

According to the majority of bankruptcy courts considering the issue, however, a hotel mortgagee does not deserve similar treatment. These courts have concluded that "rents" and "profits" as used in section 552(b) mean "rents and profits" in the nature of realty; since hotel guests are not tenants and thus cannot pay "rent," room revenues are not rents or profits within the meaning of section 552(b).<sup>50</sup> Instead, these courts have characterized room rev-

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47. 11 U.S.C. § 552(b) (1988) (emphasis added). Section 552(b) was enacted in its present form in 1978, well before the current debate over the characterization of hotel room revenues.

48. See 124 CONG. REC. H11,097 (daily ed. Sept. 28, 1978) (floor statement of Rep. Edwards upon compromise version of § 552(b)) ("Proceeds coverage, but not after acquired property clauses, are valid under title 11."); 124 CONG. REC. S17,414 (daily ed. Oct. 6, 1978) (floor statement of Sen. DeConcini) (same).

49. See 11 U.S.C. § 363(a) (1988).

50. See, e.g., *In re Northview Corp.*, 130 B.R. 543, 548 (Bankr. 9th Cir. 1991); *In re The Green Corp.*, No. 92-10903, 1993 WL 180921, at \*4-7 (Bankr. D. Me. May 18, 1993); *In re General Associated Investors Ltd. Partnership*, 150 B.R. 756, 759-62 (Bankr. D. Ariz. 1993); *In re Thunderbird Inn, Inc.*, 151 B.R. 224, 226-27 (Bankr. D. Ariz. 1993); *Financial Sec. Assurance, Inc. v. Days Cal. Riverside Ltd. Partnership*, No. S-92-119GEB, 1992 WL 471706, at \*2-4 (E.D. Cal. Aug. 18, 1992); *In re Corpus Christi Hotel Partners*, 133 B.R. 850, 854-55 (Bankr. S.D. Tex. 1991); *In re Airport Inn Assocs.*, 132 B.R. 951, 960 (Bankr. D. Colo. 1991); *In re Sacramento Mansion, Ltd.*, 117 B.R. 592, 602-07 (Bankr. D. Colo. 1990); *In re Investment Hotel Properties*, 109 B.R. 990, 994-97 (Bankr. D. Colo. 1990).

enues as accounts and have applied section 552(a) to defeat the mortgagee's lien upon postpetition room revenues.

The decision of the Bankruptcy Appellate Panel of the United States Court of Appeals for the Ninth Circuit in *In re Northview Corp.*<sup>51</sup> typifies these cases. Calmark Properties, Inc. ("Calmark"), a subsidiary of the debtor Northview Corp. ("Northview"), leased two California hotels, each encumbered by a leasehold deed of trust in favor of Greyhound Real Estate Finance Company ("Greyhound"). The deeds of trust granted Greyhound a lien upon "all income, rents, royalties, revenues, issues, profits, fees, and other proceeds" of the hotels.<sup>52</sup> Greyhound properly recorded the deeds of trust and filed accurate UCC-1 financing statements in all required offices.<sup>53</sup> Immediately after Northview filed a Chapter 11 petition,<sup>54</sup> Greyhound moved to condition Northview's use of the hotels' room revenues. The court noted that Greyhound's filings gave it a perfected security interest in prepetition room revenues, but still denied Greyhound's motion, concluding that Greyhound possessed no security interest in postpetition room revenues under section 552(a).<sup>55</sup> The court rejected Greyhound's position that the room revenues were "rents," "profits," or "proceeds" under section 552(b):

The revenues are not "proceeds," which refers to secured prepetition personal property which is converted into some other property. Nor are the revenues "profits," which refers to sale of real property to which a security interest was attached and perfected before the bankruptcy filing. Finally, the revenues are closest in kind to "rents," since they are generated by the hotels' provision of room rentals and related services and do not arise from the mere conversion of pre-petition collateral. However, as discussed revenues must be deemed "accounts" and not "rents" in light of the case authority on this question.<sup>56</sup>

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51. 130 B.R. 543 (Bankr. 9th Cir. 1991).

52. *Id.* at 544. The deeds of trust also contained a specific assignment of rents provision, under which Calmark assigned "all income, rents, royalties, revenues, issues, profits, fees, and other proceeds (including, without limitation, room sales)" from the hotels. *Id.* at 545.

53. *Id.*

54. *Id.* at 543, 545. Immediately before the filing, Calmark had assigned its interest in the leases back to Northview, apparently out of concern that the original transfer of the leases to Calmark would have been an avoidable transfer under 11 U.S.C. § 548. *Id.* at 545.

55. *Id.* at 545-46.

56. *Id.* at 548 (citations omitted). The *Northview* court's definition of "profits" seems clearly at odds with a plethora of court decisions indicating that the meaning of "profits" as used in the term "rents and profits" is either synonymous with rents, *see Grusmark v. Echelman*, 162 F. Supp. 49, 51 n.1 (S.D.N.Y. 1958), or is a broader term



With its reasoning sagging under the weight of bankruptcy court authority, the court permitted Northview to use fifteen months' worth of net postpetition room revenues free and clear of Greyhound's prepetition lien.<sup>57</sup>

## II. CONCEPTUAL FORMALISM AND THE HOTEL BANKRUPTCY CASES—CAN HOTEL ROOM REVENUES BE “RENTS”?

The hotel bankruptcy cases discussed above are monuments to the danger of conceptual formalism in legal analysis. John Dewar has characterized conceptual formalism

as the view that either judges *do*, or *ought* to, decide cases according to a limited range of pre-ordained conceptual categories; that the categories have distinguishable features and consequences, and that it is the task of the judge to determine whether the differing conceptual requirements are satisfied, and to allow the result to be dictated accordingly. Put another way, “conceptual formalism” is characterized by a refusal to regard anything other than conceptual arguments (and some strictly limited “policy” arguments) as reasons or justifications for decisions, or as the basis for criticism. At the same time, there is a compara-

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that includes rents, *see* *Fairchild v. Gray*, 242 N.Y.S. 192, 196 (Cayuga County Ct. 1930); *see also* KENELM E. DIGBY, AN INTRODUCTION TO THE HISTORY OF THE LAW OF REAL PROPERTY 231 (1875) (treating “rents” as subset of “profits”); 1 HERBERT T. TIFFANY, A TREATISE ON THE LAW OF LANDLORD AND TENANT § 165, at 1009 (1910) (rent issues directly out of land, “as part of its actual or possible profits”).

As Part IV argues, the *Northview* court's definition of the term “proceeds” can be criticized on policy grounds, since as an economic matter room revenues can be characterized as proceeds of the hotel's economic value. *See infra* notes 220–250 and accompanying text.

57. To add insult to injury, § 552(a) will continue to deny the hotel mortgagee any lien upon room revenues generated throughout the bankruptcy, which provides the debtor with extra revenue for a hostile plan confirmation battle with the mortgagee. *See Silverman & Grohsgal, supra* note 2, at 31. Giving the debtor unfettered control of project cash flows thus provides the debtor with a *substantial* disincentive to seek prompt confirmation of a reorganization plan.

One commentator has argued that a mortgagee's secured claim against the debtor should be valued at zero if the debtor avoids the mortgagee's lien against postpetition revenues:

The value would have to be the value of sticks and bricks comprising the hotel without the income produced therefrom. A common basis for valuing income-producing properties is the “income approach.” Using the “income approach” to value a creditor's lien on a hotel, postpetition, would necessarily result in a zero value. Imagine the secured creditor's dismay when confronted with the debtor's argument that the debtor *only* has to pay the present value of the creditor's secured claim and the value of the security (the lien on the postpetition revenue) is equal to zero.

Averch, *supra* note 6, at 504 (footnotes omitted). Averch's position is certainly correct as an economic matter. *See infra* Part III. Fortunately, it has not yet been embraced by any bankruptcy courts.

tively narrow intellectual concern with defining the limits of, and differences between, conceptual categories.<sup>58</sup>

The influence of conceptual formalism in the hotel bankruptcy cases is obvious. No one can question the premise that tenants pay rent, but it is quite another thing to say that *only* a tenant pays rent. Yet the hotel bankruptcy cases are based upon the assumption that the latter conclusion conceptually follows from the former—because tenants pay rent, the term “rent” is limited to payments made to a landlord by a tenant who possesses a nonfreehold estate.<sup>59</sup>

This conception of “rent” is both illogical and historically wrong. Part II traces the historical parameters of the common law’s conception of rent and demonstrates that the conceptual formalism of the hotel bankruptcy cases narrows the meaning of “rent” beyond its original scope. The common law did not limit the term “rent” solely to the landlord-tenant relationship;<sup>60</sup> instead, the term reflected the payment obligation incurred by an occupier of land in exchange for the right of occupation bestowed under his agreement with the landowner. Based upon the historical parameters of the term “rent,” as well as other theoretical and judicial conceptions of the term,<sup>61</sup> Part II argues that security law could characterize hotel room revenues (and other license fees paid by occupiers of land) as rents and profits in the nature of realty.

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58. John Dewar, *Licenses and Land Law: An Alternative View*, 49 MOD. L. REV. 741, 742 (1986); see also Robert W. Gordon, *Historicism in Legal Scholarship*, 90 YALE L.J. 1017, 1026 (1981) (characterizing tendency toward formalism as “Cartesianism,” or “the intellectual strategy of constructing highly simplified models of social reality for the sake of analytic rigor and elegance,” and noting that such an approach is often typified by selective use of history). As discussed *infra* notes 62–148 and accompanying text, the analysis of the hotel bankruptcy cases likewise suffers from blind adherence to an inaccurate historical conception of rent as being inextricably bound to the landlord-tenant relationship.

59. See, e.g., *In re Majestic Motel Assocs.*, 131 B.R. 523, 525–26 (Bankr. D. Me. 1991) (“‘[R]ent’ is associated with payments on behalf of a tenant for his interest in real property . . . . A hotel guest does not obtain an interest in the underlying real property but is a mere licensee with a personal right to use the premises.”); *In re Nendels-Medford Joint Venture*, 127 B.R. 658, 663 (Bankr. D. Or. 1991) (“[T]he term rents . . . is limited to payment for the right to possession, use and control of a legally cognizable interest in the referenced real estate.”); *In re Mid-City Hotel Assocs.*, 114 B.R. 634, 641 (Bankr. D. Minn. 1990) (“A tenant pays ‘rents’ in consideration for his use and occupancy of real estate for the term of his lease—i.e., for his legal interest in that real estate. By negative inference if nothing else, then, a hotel guest does not pay ‘rent.’”).

60. See *infra* notes 62–89 and accompanying text.

61. See *infra* notes 100–148 and accompanying text.

### A. *The Early Common Law Conception of "Rent"*

#### 1. The Early Common Law Real Property Lease

Following the Norman Conquest, tenure became the basis for the ownership of land in England. Ultimate ownership of land was vested in the King; the King's transferees (his "tenants") held the land of the King in exchange for performing feudal services for the King. In turn, the King's immediate tenants became lords in their own right, transferring to a new tenant the right to possess and occupy their land in exchange for feudal services. This process of "subinfeudation" led to a lengthening feudal chain of landholding, in which *D* (the occupier of certain land) might hold of *C*, who held of *B*, who held of *A*, who held of the King.<sup>62</sup>

The sanctity of the occupier's right to occupy the land, however, depended upon whether the occupier was considered to be "seised" of a free tenement. An occupier who was so seised was a "freeholder," and had the benefit of the assize of novel disseisin, the great possessory remedy by which one who was seised of land and who had been dispossessed wrongfully could recover possession of the land.<sup>63</sup> Yet not all land in England was occupied by persons who were seised of free tenements. Two significant occupiers of land, villein tenants and lessees, were not seised of the land at all. The first such occupier, the villein, stood in a relationship of lord and tenant with the landowner, holding the land in exchange for feudal services.<sup>64</sup> But the villein's occupation of the land was precarious; if the villein was ejected from the land, he had no recourse to

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62. THOMAS F. BERGIN & PAUL G. HASKELL, PREFACE TO ESTATES IN LAND AND FUTURE INTERESTS 1-6 (2d ed. 1984).

63. S.F.C. MILSOM, HISTORICAL FOUNDATIONS OF THE COMMON LAW 116-19 (1969); THEODORE F.T. PLUCKNETT, A CONCISE HISTORY OF THE COMMON LAW 358-60 (5th ed. 1956); ALFRED W.B. SIMPSON, A HISTORY OF THE LAND LAW 28-33, 40-44 (2d ed. 1986).

64. Unlike the freeholder, whose services were fixed by his grant, the villein's services were prescribed by his lord periodically, even day to day. R.E. MEGARRY & H.W.R. WADE, THE LAW OF REAL PROPERTY 22 (5th ed. 1984) ("When villeins 'go to bed on Sunday night they do not know what Monday's work will be'; it might be ditching, it might be threshing, it might be driving a cart.") (quoting 1 SIR FREDERICK POLLOCK & FREDERIC W. MAITLAND, THE HISTORY OF ENGLISH LAW 371 (1968)). The typical villein fulfilled three sets of obligations:

[T]he first, imposed by the custom of the manor and enforced by the manorial court, consisted both of the rendering of services and the payment of rents to the lord of the manor; the second, political in origin, but influenced during the feudal period by manorial custom, consisted chiefly of the payment of rents to the king through his local officers, or to the lord of the manor, who, under the peculiar conditions of feudal society, was usually the holder of regalia obtained by franchise or usurpation; and

the assize of novel disseisin.<sup>65</sup> Villeinage was a status, the "tenure of common laborers."<sup>66</sup>

The second "non-seised" occupier was the lessee, who held land either for a term or at the will of the lessor. Prior to the thirteenth century, terms of years were rare<sup>67</sup> and apparently were used primarily to avoid the church's prohibition upon usury.<sup>68</sup> Whether for this reason or because the lessee was not seised of a free tenement,<sup>69</sup> the common law afforded the lessee scant protection of his rights of occupancy. If dispossessed, the lessee for a term had no

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the third, in origin non-manorial like the second, consisted of the payment of tithes and rents to the church.

NELLIE NEILSON, CUSTOMARY RENTS, *reprinted in 2 OXFORD STUDIES IN SOCIAL AND LEGAL HISTORY* B5 (1910).

65. MEGARRY & WADE, *supra* note 64, at 23-24; 1 SIR FREDERICK POLLOCK & FREDERIC W. MAITLAND, *THE HISTORY OF ENGLISH LAW* 360 (1968); John F. Hicks, *The Contractual Nature of Real Property Leases*, 24 BAYLOR L. REV. 443, 447 (1972).

66. Hiram H. Lesar, *The Landlord-Tenant Relation in Perspective: From Status to Contract and Back in 900 Years?*, 9 KAN. L. REV. 369, 369 (1961). Despite his precarious status, the villein was not without some protection:

For customs arose that the tenants did not lose their lands unless they did some act recognized as meriting forfeiture, and the "custom of the manor" became recognized as "law" in the manor court. The lord could not be sued in his own court, but he usually obeyed the custom. Eventually, by the end of the fifteenth century, the common-law courts were ready to come to the assistance of any tenant ejected by his lord other than in accordance with the custom of the manor . . . .

*Id.* at 369-70 (footnotes omitted).

67. 1 POLLOCK & MAITLAND, *supra* note 65, at 111. Both Henry Bracton and Glanvill, however, wrote of the "letting and hiring" of things, including land. See 2 BRACTON, *ON THE LAWS AND CUSTOMS OF ENGLAND* 183 (George E. Woodbine ed. & Samuel E. Thorne trans., 1968) ("By a letting and hiring a thing is usually given either for use or occupation, as where one lets his movable or immovable property to another for a specified time in return for a certain payment; he who lets is bound to give up the thing let for use and the hirer obliged to pay the hire."); *THE TREATISE ON THE LAWS AND CUSTOMS OF THE REALM OF ENGLAND COMMONLY CALLED GLANVILL* X, at 18 (G.D.G. Hall ed., 1965) ("A thing is sometimes owed on a letting and on a hiring, as when anyone lets out some thing of his to another for a certain time and at a certain rent. Here the letter is bound to give the use of the thing let, and the hirer on his part is bound to pay the rent.").

68. The church prohibited moneylending at interest, but a lessee could circumvent this prohibition by "lending" money to the owner of land in exchange for a term of years, from which the lessee could collect rents and profits. Since the lessee's entitlement to rents and profits was not limited to the amount "loaned," any excess rents and profits were a substitute for interest on the money "loaned." PLUCKNETT, *supra* note 63, at 572-73; Hicks, *supra* note 65, at 448; Lesar, *supra* note 66, at 370. These origins may explain why the early lessee was considered "in very bad company among usurers and other scoundrels who prey upon society." PLUCKNETT, *supra* note 63, at 573.

69. Hicks, *supra* note 65, at 449.

possessory remedy, only an action of covenant against his lessor.<sup>70</sup> The occupancy of a lessee at will was more precarious yet, for he could be "put out at the pleasure of the lessor."<sup>71</sup> Unlike the villein, however, the lessee's interest was based not upon status but upon contract. As Milsom noted:

[T]he creation of a lease for years was not at first the grant of a property right but the making of a contract; and the only tenure to survive in England today did not begin as a tenure at all. There was no relationship of lord and man between the parties and no homage was done. . . . Indeed, in comparison with an ideal feudal grant, the parties are reversed. There, the grantor was at first the buyer, the services the thing bought, and the land the price paid. But in the case of a term of years, the grantor was clearly in the position of seller, and the termor was an investor and sometimes in effect a money-lender.<sup>72</sup>

Between the twelfth and fourteenth centuries, the lessee for years began to replace the villein tenant, due to a combination of legal,<sup>73</sup> financial,<sup>74</sup> and socioeconomic factors<sup>75</sup> that brought the

70. See 2 POLLOCK & MAITLAND, *supra* note 65, at 106–07 ("At the end of the twelfth century the law was apparently endeavouring to regard the termor as one who has no 'real' right, no right in the land; he enjoys the benefit of a covenant (*conventio*); he has a right *in personam* against the lessor and his heirs. His action is an action of covenant (*quod teneat ei conventionem factam*) . . . . But as against the world at large he is unprotected."); see also Hicks, *supra* note 65, at 449; Lesar, *supra* note 66, at 370.

71. SIR EDWARD COKE, THE FIRST PART OF THE INSTITUTES OF THE LAWS OF ENGLAND Bk. 1, Ch. 10, § 84, at 63a (Francis Hargrave & Charles Butler eds., 15th ed. 1794).

72. MILSOM, *supra* note 63, at 127–28; see also BRACTON, *supra* note 67, at 232 ("letters" did not do homage); COKE, *supra* note 71, Bk. 2, Ch. 1, § 90, at 66b ("[N]one shal do homage but such, as have an estate in fee simple, or fee taile, in his owne right, or in the right of another."); *id.* Bk. 1, Ch. 10, § 84, at 63a ("For tenant at will, that may be put out at pleasure, shall not doe fealty."); ALBERT M. KALES, ESTATES, FUTURE INTERESTS AND ILLEGAL CONDITIONS AND RESTRAINTS IN ILLINOIS § 21 (1920) ("In the feudal scheme of society the term for years seems to have had no place. No feudal dues or services were exacted from tenants for years. The possession did not count for anything from the feudal point of view. The relation between the landlord and tenant was only that produced by a personal contract.").

73. Milsom argued that the husbandry lease developed to fill a gap left by the *Statute Quia Emptores*, which forbade subinfeudation in fee simple. MILSOM, *supra* note 63, at 100 ("[A]fter *Quia Emptores*, the lease was the simplest secure way of parting with the land in return for a fixed annual income . . .").

74. As the mortgage became an acceptable manner of using land to secure indebtedness, "the term of years became disassociated with the unsavory aspects of moneylending." Hicks, *supra* note 65, at 449; see also PLUCKNETT, *supra* note 63, at 574.

75. The Black Death reduced the agricultural labor force, opening opportunities for villeins to secure opportunity outside the manor, and many became agricultural lessees for years. PLUCKNETT, *supra* note 63, at 573–74; Hicks, *supra* note 65, at 449; Lesar, *supra* note 66, at 370.

lease into more common use. But without the benefit of the assize of novel disseisin, the lessee's right of occupancy was essentially contractual in nature.<sup>76</sup> The early lessee's right to occupy land thus provides an interesting comparison to the holder of a modern license to occupy land, such as a hotel guest—each with a “contractual” right to occupy land, but neither with a possessory remedy if that right of occupation is disturbed.

## 2. Early Common Law Conceptions of “Rent”

Early common law characterized an occupier's obligation to pay for his rights (and the landowner's correlative right to payment) as “rent.” In summarizing ancient common law authorities, Blackstone described rent as

a compensation, or return; it being in the nature of an acknowledgement given for possession of some corporeal inheritance. It is defined to be a certain profit issuing yearly out of lands and tenements corporeal. It must be a *profit*; yet there is no occasion for it to be, as it usually is, a sum of money . . . . It may also consist in services or manual operations; as, to plough so many acres of ground, to attend the king or the lord to the wars, and the like; which services in the eye of the law are profits. . . . It must, lastly, issue out of *lands and tenements corporeal* . . . .<sup>77</sup>

The landowner's right to collect payment from occupiers of land was an intangible right, of course, yet landowners and the common law conceptualized this right as one that attached to and sprang from the land to which it related. The common law “reified” the right to collect payment from occupiers into a form of property, a “rent.” The common law further characterized that “rent” as an incorporeal hereditament governed by the same rules as the land from which it had sprung, a “piece[ ] of property like land itself.”<sup>78</sup>

Early common law recognized four types of rent: “rent service,” “rent distrainable of common right,” “rent seck,” and “rent

76. MEGARRY & WADE, *supra* note 64, at 24; see also MILSOM, *supra* note 63, at 127; Hicks, *supra* note 65, at 449; Lesar, *supra* note 66, at 370.

77. 2 SIR WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND \*41. Other authorities provide similar definitions. See, e.g., W.H. BURTON, AN ELEMENTARY COMPENDIUM ON THE LAW OF REAL PROPERTY 328 (1839) (“A RENT, such as a subject may have according to the Common Law, consists in a right to the periodical receipt of money or money's worth, in respect of lands which are held in possession . . . by him from whom the payment is due.”).

78. SIMPSON, *supra* note 63, at 104. Blackstone listed ten incorporeal hereditaments recognized by the common law—advowsons, tithes, commons, ways, offices, dignities, franchises, corodies, annuities, and rents. 2 BLACKSTONE, *supra* note 77, at \*20–43.

charge.”<sup>79</sup> The first type, “rent service,” was a rent reserved upon a grant that created a tenurial relationship between the lord and the occupier.<sup>80</sup> The lessee of land, however, did not stand in a tenurial relationship with his grantor,<sup>81</sup> so the lessee’s obligation was not rent service, but “rent distrainable of common right.”<sup>82</sup> Both “rent service” and “rent distrainable of common right,” however, were notable for the lord’s right of distress. If the occupier failed to satisfy the rent at the time and place required, the owner could seize the occupier’s chattels located on the land as security for the unpaid rent.<sup>83</sup>

Prior to 1290, the transfer of an inheritable interest in land created a relationship of tenure between transferor and transferee. Following the *Statute Quia Emptores*<sup>84</sup> in 1290, however, the grantor of a generally inheritable interest in land could no longer create

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79. Most common law authorities speak of only three types: rent service, rent charge, and rent seck. See, e.g., 2 BLACKSTONE, *supra* note 77, at \*41–43; 1 TIFFANY, *supra* note 56, § 167, at 1011. Lord Coke identified a fourth type, “rent distreinable of common right,” or the rent collected from a lessee who had not done fealty. COKE, *supra* note 71, Bk. 1, Ch. 8, § 72, at 57b (lessor upon lease at will “may distreine for the rent, and yet it is no rent service, for no fealty belongeth thereunto, but a rent distreinable of common right”). As noted *infra* note 82 and accompanying text, rents payable by those who had not done fealty did not satisfy the common law definition of rent service, rent charge or rent seck.

By the time of Blackstone and Tiffany, the common law had engrafted principles of tenure upon the leasing of land. See *infra* notes 90–99 and accompanying text. Homage and fealty had become “meaningless formalities never observed in practice.” CORNELIUS J. MOYNIHAN, INTRODUCTION TO THE LAW OF REAL PROPERTY 20 (2d ed. 1988). Thus, modern authorities may have concluded that no further basis existed for characterizing any rent as “rent distreinable of common right.”

80. *Rent-service* is so called because it hath some corporeal service incident to it, as at the least fealty, or the feodal oath of fidelity. For, if a tenant holds his land by fealty, and ten shillings rent; or by the service of ploughing the lord’s land, and five shillings rent; these pecuniary rents, being connected with personal services, are therefore called rent-service.

2 BLACKSTONE, *supra* note 77, at \*41–42; see also MEGARRY & WADE, *supra* note 64, at 818; 1 TIFFANY, *supra* note 56, § 167, at 1011. Consistent with this characterization, rent paid by a lessee who had not done fealty was not rent service. See *infra* note 82.

81. See *supra* notes 67–72 and accompanying text.

82. COKE, *supra* note 71, Bk. 1, Ch. 8, § 72, at 57b (lessor upon lease at will “may distreine for the rent, and yet it is no rent service, for no fealty belongeth thereunto”).

83. 2 BLACKSTONE, *supra* note 77, at \*42; see also DIGBY, *supra* note 56, at 166 n.1; 1 TIFFANY, *supra* note 56, § 167, at 1011–12; 2 TIFFANY, *supra* note 56, § 325, at 1985–86. If the occupier was a tenant holding the land in fee simple, the right of distress was incident to the lordship. If the occupier held a lesser interest, the right of distress was incident to the owner’s reversion. 1 TIFFANY, *supra* note 56, § 167, at 1012.

84. Stat. Westminster III (18 Edw. 1, c.1) (1290).

a relationship of tenure with his grantee.<sup>85</sup> Although the transferor of such an interest still could reserve a rent, since the transferee was not a “tenant” of the grantor that rent was not rent service. Instead, the common law treated that obligation as “rent seck,”<sup>86</sup> unless the grantee agreed that the grantor should have the right of distress for unpaid rent, in which case the rent was “rent charge.”<sup>87</sup>

This synopsis illustrates that the common law has not always limited the concept of “rent” to the landlord-tenant relationship, as the hotel bankruptcy cases appear to suggest. The early lessee of land was not a tenant,<sup>88</sup> yet certainly paid rent; likewise, the grantee of a fee simple after *Quia Emptores*, while not a tenant of his grantor, still might have paid rent to his grantor.<sup>89</sup> “Rent” was never simply the obligation incurred by a tenant; instead, it was the obli-

85. See, e.g., JOHN E. CRIBBET & CORWIN W. JOHNSON, *PRINCIPLES OF THE LAW OF PROPERTY* 36–37 (3d ed. 1989); ROGER A. CUNNINGHAM, ET AL., *THE LAW OF PROPERTY* § 1.6, at 21–22 (1984); MOYNIHAN, *supra* note 79, at 19–20.

86. See 2 BLACKSTONE, *supra* note 77, at \*42 (rent seck is “nothing more than a rent reserved by deed, but without any clause of distress”); 1 TIFFANY, *supra* note 56, § 167, at 1012. Rent seck might also arise if a landowner “severed” a rent from the land—*i.e.*, if a landowner transferred his interest in the land while retaining the right to rents, or transferred his right to rents while retaining his interest in the land. If a rent was severed from the land, the holder of the rent could no longer enforce it via distress. *Id.* This “severed” rent was also called rent seck, or “dry rent.”

87. See 2 BLACKSTONE, *supra* note 77, at \*42 (“A *rent-charge*, is where the owner of the rent hath no future interest, or reversion expectant in the land; as where a man by deed maketh over to others his *whole* estate in fee simple, with a certain rent payable thereout, and adds to the deed a covenant or clause of distress . . .”).

88. See *supra* notes 67–72 and accompanying text; see also MEGARRY & WADE, *supra* note 64, at 43 (“By a paradox of history the relationship of landlord and tenant, originally no tenure at all, is now the only tenure which has any practical importance.”).

89. While such a rent was not “rent service,” it was still a rent. Perhaps the only meaningful difference was that a covenant to pay such a rent would not run with the land to bind personally any successors or assigns of the grantee.

But when the statute of *quia emptores* abolished subinfeudation . . . privity no longer existed in cases where a fee was transferred and no reversion left in the donor, and it became a rule that covenants which imposed any charge, burden or obligation upon the land were held not to be incident to it, and therefore incapable of passing with it to an assignee; thus, if the owner of land granted it *in fee*, reserving to himself a rent which the grantee covenanted to pay, here, though the covenant was to be performed out of the land, yet the assignee of the covenantor would hold the land discharged from its liability.

WILLIAM H. RAWLE, *THE LAW OF COVENANTS FOR TITLE* 294 n.2 (5th ed. 1887); see also *Ingersoll v. Sergeant*, 1 Whart. 336, 350 (Pa. 1836) (“[A] covenant to pay a *rent-charge* is merely *personal* and *collateral* to the land, and therefore will not render the assignee liable to an action of covenant for the non-performance of it.”) (citing *Brewster v. Kidgill*, 1 Ld. Raym. 317, 12 Mod. 166 (1698)); ANSON BINGHAM & A. COLVIN, A



gation incurred by an occupier of land in exchange for the right to possession of the land.

### 3. Development of the Lessee's "Possessory" Interest

If "rent" is the obligation an occupier incurs in exchange for "possession" of land, then what level of "possession" is sufficient to generate an obligation for rent? To most bankruptcy courts, "possession" means the level of possession of a holder of an estate in land: actual possession secured by a possessory remedy, or specifically enforceable proprietary control of the land. If *X* is a hotel guest who occupies a room but has no possessory remedy, property law might say that *X* does not have legal possession of the room. For the bankruptcy courts, this reasoning leads inexorably to the conclusion that *X* is not a tenant and thus does not pay "rent."

History indicates, however, that the term "possession" did not have such a fixed and narrow meaning as that term related to an occupier's rent obligation. Although origins are not "an infallible key to modern classification,"<sup>90</sup> the original meaning of "posses-

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TREATISE ON RENTS, REAL AND PERSONAL COVENANTS AND CONDITIONS 47 (1857) (citing earlier edition of Rawle's treatise).

As a practical matter, such a rent would have operated either as an annuity upon the land, *see* MEGARRY & WADE, *supra* note 64, at 815, or as a reservation of purchase money. While some authorities have characterized sums reserved upon the sale of land as not "rent," *see, e.g.,* 1 TIFFANY, *supra* note 56, § 169, at 1024, this seems plainly wrong. As Bingham and Colvin noted in their treatise on rents, a perpetual rent-charge upon land effectively represents the purchase price of that land. Bingham and Colvin demonstrated this point by comparing two hypothetical conveyances of a farm in fee simple, one for an annual perpetual rent and the other for fourteen annual payments:

In each . . . the grantor sold and conveyed his estate to the grantee, *his heirs and assigns*, forever. Stop there, and they are precisely alike. If any dissimilarities of principle exist they must be beyond that point, and in some manner arise out of the provisions in relation to the payment of the purchase money. . . . In the one case, the purchase money is payable in fourteen annual installments; and, in the other, in a certain amount annually forever. Can this affect the character of the covenant so that in the one case it will run with the land and in the other not? Would there not equally be a sale of the premises in the one case as in the other? . . .

That the sum or amount to be paid, may, by the covenants, be denominated rent, cannot have any controlling effect. We are dealing with things, not names. Covenants of payment, in a limited number of installments, may be as appropriately called rent as similar covenants in an indefinite number; and in either case they would be none the less the purchase price.

BINGHAM & COLVIN, *supra*, at 70-72.

90. John A. Humbach, *The Common-Law Conception of Leasing: Mitigation, Habitability and Dependence of Covenants*, 60 WASH. U. L.Q. 1213, 1220 n.30 (1983) (quoting S.F.C. MILSOM, *HISTORICAL FOUNDATIONS OF THE COMMON LAW* 120, 127-29 (1969)).

sion" is important to an accurate understanding of the true scope of the term "rent." Writing in the thirteenth century, Bracton spoke of "possession" in clearly *relative* terms, describing both the freeholder and the lessee (even the lessee at will) as having "possession" of the land.<sup>91</sup> In a purely conceptual sense, of course, the common law had to characterize the lessee as having some right to "possession" in order to classify the lessee's obligation as "rent."

Yet the early lessee was not seised of a free tenement; his rights were ones that modern law would characterize as purely contractual ones, unprotected by possessory remedies.<sup>92</sup> Only beginning in the thirteenth century did the common law begin to provide the lessee with remedies that modern law characterizes as "possessory" rights. First, the lessee obtained limited possessory remedies against persons claiming through the lessor:

The first extension from covenant appears to have been a definite event about 1235, . . . the introduction of a writ for use against the lessor's grantee. The lessee ejected by him would have a remedy in covenant against his lessor, but could not get the land back because the lessor no longer had it; and against the grantee there would be no action at all. The writ *quare ejecit infra terminum* allowed direct recovery of the land from the grantee; and the lease, like the equity of redemption and the restrictive covenant in later centuries, had taken the first seductive step on the path from contract to property.<sup>93</sup>

After 1235, however, two centuries passed during which the lessee had no rights in rem against other third party ejectors.<sup>94</sup> Not until 1499 and the development of the action of ejectment did the courts

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91. Bracton described even the lessee at will as having "possession" of land: Some possessions are precarious, as where one grants to another at will the right to use his house as a dwelling or a usufruct in his property, which is properly called bare since it may be revoked in season and out . . . . There is possession granted for a price, and it is then important whether the price established is certain or uncertain. If certain and for a definite time, or in perpetuity, he cannot be ejected at the will of the grantor; if uncertain, then let him proceed as in the case of *precarium* . . . .

2 BRACTON, *supra* note 67, 123-24; *see also* SIMPSON, *supra* note 63, at 40 (noting that both lessee for years and freeholder were "equally in *de facto* possession").

92. *See supra* notes 67-76 and accompanying text.

93. MILSOM, *supra* note 63, at 129; *see also* MEGARRY & WADE, *supra* note 64, at 1156; PLUCKNETT, *supra* note 63, at 571; 2 POLLOCK & MAITLAND, *supra* note 65, at 107-08; SIMPSON, *supra* note 63, at 74-75.

94. The ejected lessee could bring a special writ in trespass, *de ejectione firmæ*, in order to recover damages (but not possession) against such third parties. MILSOM, *supra* note 63, at 129-31; PLUCKNETT, *supra* note 63, at 571; 2 POLLOCK & MAITLAND, *supra* note 65, at 109; Hicks, *supra* note 65, at 450.

permit the wrongfully ejected lessee to recover the land from any person disturbing his occupancy.<sup>95</sup>

Why did the common law finally grant the lessee a possessory remedy? As Dean Hiram Lesar noted:

That [the lessee] did secure it was due to social and economic causes. The lessee for years had replaced the villein, but the landlords, without a labor-service system, tended to convert arable land to pasture, a practice the government desired to end. Providing the tenant with a possessory remedy to protect his interest served this purpose.<sup>96</sup>

Some conceptual framework was necessary to accomplish this result, and the readiest framework for the task was the feudal relationship of tenure.<sup>97</sup> As Professor John Humbach has noted, applying principles of tenure to the lessor-lessee relationship "supplied an analytical basis for protecting most of the then usual expectations of parties to leasing transactions."<sup>98</sup> Girded with a possessory remedy, the lessee came to be regarded as someone who possessed a "real" or "possessory" right.<sup>99</sup> Nevertheless, having such a remedy was never a necessary condition for characterizing the lessee's obligation as rent.

#### B. *Extricating the True Nature and Scope of Rent*

In summarizing the law of landlord and tenant, nineteenth and twentieth century scholars defined rent in a manner that laid the framework for the conceptual formalism displayed by the hotel

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95. 3 BLACKSTONE, *supra* note 77, at \*200-01; 7 SIR WILLIAM HOLDSWORTH, A HISTORY OF ENGLISH LAW 4 (1956); MEGARRY & WADE, *supra* note 64, at 1156-57; PLUCKNETT, *supra* note 63, at 574; SIMPSON, *supra* note 63, at 144.

96. Lesar, *supra* note 66, at 370 (footnotes omitted); *see also* Humbach, *supra* note 90, at 1221-22.

97. After *Quia Emptores*, the feudal hierarchy of fee simple ownership had crumbled. Still, *Quia Emptores* applied only to grants in fee simple, and a landowner could create a relationship of tenure upon a grant of lesser conveyances. MOYNIHAN, *supra* note 79, at 19-20; Humbach, *supra* note 90, at 1222-23 & n.39.

98. Humbach, *supra* note 90, at 1222-23. The objective of protecting ejected lessees required some framework upon which to regard the lessee's rights as rights in rem, specifically enforceable against third parties. As Professor Humbach argued, "modern contract theory, which provides a basis only for in personam rights, probably would not have served the intended purpose even if it had existed." *Id.* at 1221 n.36.

99. Hicks, *supra* note 65, at 450; Lesar, *supra* note 66, at 371. Despite the lessee's new status as an estate holder, the common law continued to treat the lessee's interest as personalty for other purposes, such as descent and distribution. By 1499, leases "had become too firmly established as personalty for this change [the action of ejectment] to make any difference to their status." DAVID J. HAYTON, MEGARRY'S MANUAL OF THE LAW OF REAL PROPERTY 18 (6th ed. 1982); *see also* MOYNIHAN, *supra* note 79, at 57.

bankruptcy cases. For example, Tiffany's treatise defined rent as "a tribute or return of a certain amount . . . payable by one having an estate in land, as compensation for his use, possession and enjoyment of the land."<sup>100</sup> By defining rent as an obligation payable by one possessing an estate, Tiffany blended together rights and remedies, with no distinction between the existence of a right to occupy land and the existence of a remedy for protecting that right. Based upon this conception of common law "rent," modern courts have concluded that "rent" can arise only in exchange for legal possession of land, that is, possession secured by a possessory remedy.

This limitation upon the scope of the term "rent" seems plainly contrary to its original historical scope. The earliest villein tenant or lessee of land had the *right* to occupy land, subject to the obligation to pay rent. While that right was not "possessory" in the modern sense of the term, that does not mean that both the villein tenant and the lessee were without any "possession," for the term "possession" never had but one talismanic meaning.<sup>101</sup> In its original scope, the "possession" necessary to trigger one's obligation to pay rent was *de facto* possession—actual possession referable to the occupier's rights respecting the land, not to the occupier's remedies. Viewed in that historical context, "rent" could include any sum paid for the occupier's right to use and occupy land.

Consistent with this historical meaning, one can use the term "rent" to characterize the obligation of the holder of a license to occupy land, such as a modern hotel guest. As discussed below, this broader conception of rent is consistent with the conception of rent under the civil law tradition.<sup>102</sup> In addition, this broader conception finds support within the common law tradition, particularly in judicial opinions involving oil and gas leasing and lodgers.<sup>103</sup>

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100. 1 TIFFANY, *supra* note 56, § 165, at 1009 (emphasis added).

101. Scholars have often suggested that the term "possession" necessarily must be defined in relative terms to have any utility as a concept of property law. See Thomas L. Shaffer, *The "New" Property Law: "Reports of Litigation Are Wreckage from Failed Attempts at Harmony,"* PREVENTIVE L. REP., June 1992, at 8 (first-year property students are "supposed to learn that the legal notion of possession of property is as evanescent as probable cause in torts or promissory estoppel in contracts"); Burke Shartel, *Meanings of Possession*, 16 MINN. L. REV. 611, 612 (1932) (arguing "that there are many meanings" of "possession," which can be defined only with reference to context).

102. See *infra* notes 104–118 and accompanying text.

103. See *infra* notes 119–147 and accompanying text.

## 1. The Civil Law Conception of Rent

The civil law conception of rent provides a stark contrast to the narrower conception articulated in the hotel bankruptcy cases. In the civil law tradition, "ownership of a thing includes also the objects which it is capable of producing, either by itself, or with human help, as well as of monetary benefits which can be gained from it."<sup>104</sup> The civil law characterizes these "objects produced by a thing" as profits and further distinguishes between "profits and gains in general and those which have the character of fruits."<sup>105</sup> Fruits are either natural profits, which "come from the thing itself," or civil profits, which are "payments due by another and based on an obligation which rests on the enjoyment of the thing."<sup>106</sup> Within the category of civil profits, the civil law includes "rent."<sup>107</sup>

In classifying an occupier's obligation as "rent," however, the civil law accords no consequence to the occupier's remedies, that is, whether the occupier's rights are "real" rights or "personal" rights. In Louisiana, for example, a grantee who receives outright ownership of land may agree to pay rent to his grantor under the terms of the conveyance.<sup>108</sup> In addition, one who holds a right of habitation, the "right of a natural person to dwell in the house of another," may agree to pay rent to the owner of the house.<sup>109</sup> These rights are "real" rights, for which the holder has possessory remedies.<sup>110</sup>

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104. 2 CIVIL LAW TRANSLATIONS, AUBRY & RAU, DROIT CIVIL FRANÇAIS § 192, at 186 (Vol. II, 7th ed. 1966) [hereinafter AUBRY & RAU].

105. *Id.* (emphasis omitted).

106. *Id.* § 192, at 186 n.34. In the civil law tradition, civil profits "do not come from the thing itself and obtain the character of profits only by virtue of the law." *Id.*

107. *Id.* § 192, at 186 (civil profits include sums paid by lessee to landowner for "rents of houses, shops, and factories, [and] farm rents") (footnotes omitted).

108. Such a rent is called a "rent of lands." See LA. CIV. CODE ANN. art. 2779 (West 1952) (rent of lands is a contract "by which one of the parties conveys and cedes to the other a track [sic] of land . . . and stipulates that the latter shall hold it as owner, but reserving to the former an annual rent . . . which the other party binds himself to pay him"). The rent of lands is roughly analogous to the common law rent charge. See *supra* note 87 and accompanying text.

109. LA. CIV. CODE ANN. art. 630 (West 1980). The right of habitation may be created gratuitously (at no rental) or onerously (with rental). *Id.* cmt. (d); see also *Louis v. Garrison*, 64 So. 2d 254, 257 (La. Ct. App. 1953) (gratuitous); *Chenevert v. Lemoine*, 52 La. Ann. 586 (1900) (same).

110. The real remedies include the petitory action and the possessory action. See, e.g., LA. CODE CIV. PROC. ANN. art. 3651 (West Supp. 1992) ("The petitory action is one brought by a person who claims the ownership, but who is not in possession, of immovable property or of a real right therein, against another who is in possession or who claims the ownership thereof adversely, to obtain judgment recognizing the plaintiff's ownership."); *id.* art. 3655 ("The possessory action is one brought by the possessor of immovable property or of a real right therein to be maintained in his possession of the

In contrast, the civil law lessee of land historically received no "real" right in the leased premises. The civil law treated the lease of land as purely a contract rather than a conveyance of ownership.<sup>111</sup> The lease entitled the lessee to "peaceable possession" of the premises,<sup>112</sup> but the civil law termed this right of possession "precarious possession."<sup>113</sup> The lease did not convey ownership to the lessee;<sup>114</sup> it merely granted the lessee a personal right vis-à-vis the lessor, one that was not protected by the real remedies.<sup>115</sup> The civil law thus treated the lessee much like her pre-1235 common law counterpart—as an occupier who merely held "for the account of another" and who had "only a personal right of enjoyment."<sup>116</sup> Although the civil law lessee had no possessory remedy,<sup>117</sup> she unquestionably

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property or enjoyment of the right where he has been disturbed, or to be restored to the possession or enjoyment thereof when he has been evicted."). As discussed in the following text, these actions were not available to lessees, whom the civil law treated as mere "precarious possessors."

111. Ferdinand F. Stone, *A Primer on Rent*, 13 TUL. L. REV. 329, 342 (1939); see also LA. CIV. CODE ANN. art. 2669 (West 1952) ("*Lease or hire* is a synallagmatic contract, to which consent alone is sufficient, and by which one party gives to the other the enjoyment of a thing, or his labor, at a fixed price."); FRENCH C. CIV. art. 1709 (concerning rental of things); ITALIAN C.C. § 1571 ("A contract of lease is one by which one party binds himself to let the other enjoy a movable or immovable thing for a given period of time at a fixed compensation.").

112. Cf. LA. CIV. CODE ANN. art. 2692 (West 1952) ("The lessor is bound . . . [t]o cause the lessee to be in a peaceable possession of the thing during the continuance of the lease.").

113. Cf. *id.* art. 3437 ("The exercise of possession over a thing with the permission of or on behalf of the owner or possessor is precarious possession."); *id.* art. 3438 ("A precarious possessor, such as a lessee or a depositary, is presumed to possess for another although he may intend to possess for himself.").

114. See Comment, *The Louisiana Law of Lease*, 39 TUL. L. REV. 798, 826 (1965) ("A lease conveys the rights of use and enjoyment, which constitute *jura ad rem*, rights upon the thing.") (footnote omitted); see also *Rials v. Davis*, 31 So. 2d 726, 727 (La. 1947) (lease is mere transfer of use/enjoyment of property); *Gulf Refining Co. v. Glassell*, 171 So. 846, 849 (La. 1937) (same); *Roberson v. Pioneer Gas Co.*, 137 So. 46, 48 (La. 1931) (same); *Logan v. State Gravel Co.*, 103 So. 526, 526 (La. 1925) (same); *Goins v. Goins*, 580 So. 2d 477, 478 (La. Ct. App. 1991) (lease contract gives lessee right to enjoyment/use of object, but does not impart ownership).

115. Cf. LA. CODE CIV. PROC. ANN. art. 3656 (West 1961) ("A plaintiff in a possessory action shall be one who possesses for himself. . . . A predial lessee possesses for and in the name of his lessor, and not for himself."); see also *Leightsey v. Welch*, 105 So. 51, 51 (La. 1925) (tenant disturbed in possession of land not entitled to bring possessory action against adverse possessor, nor could tenant evict adverse possessor since no lease contract existed between them); *Denègre & Villeré v. Bayhi*, 35 La. Ann. 255, 256 (1883) (lessees of land not entitled to bring possessory action against persons who allegedly entered land and harvested stubble cane).

116. AUBRY & RAU, *supra* note 104, § 187, at 151.

117. In the past two decades, civil law systems have begun to accord the lessee with a possessory remedy. In 1982, for example, Louisiana changed the traditional civil law rule and determined that "[w]here there is a disturbance of possession, the possessory

paid "rent" in exchange for her personal right to occupy the premises.

Free of feudal theory and its limitations, the civil law thus conceptualized rent in a manner independent of the existence of a "real" (*i.e.*, exclusively possessory) right. This approach permits the term "rent" to be used flexibly in a manner that befits its true nature as a return for the right to use, enjoy, and occupy land. Under this view, the sums paid by a hotel guest, who occupies the land of another pursuant to her contract, constitute rent.<sup>118</sup>

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action is available to a precarious possessor, such as a lessee or a depositary, against anyone except the person for whom he possesses." LA. CIV. CODE ANN. art. 3440 (West Supp. 1992). As the Louisiana legislature noted, Article 3440 permits a lessee to bring "a possessory action against a trespasser or an adverse possessor . . ." *Id.* Revision cmt. (d); *see also* FRENCH C. CIV. art. 2282 ("Possession is protected, without regard for the basis of the right, against a disturbance which affects or threatens it.") (1975 amendment).

This change in the law demonstrates that the character of the remedy available to protect the occupier's possession has nothing to do with whether the occupier's obligation is characterized as rent. Both before and after the possessory action was available to the civil law lessee, that lessee unquestionably paid rent.

118. One Louisiana statute explicitly denominates hotel room revenues as rent. *See* LA. REV. STAT. ANN. § 9:3259 (West 1991) ("Whenever any lessee of any apartment building, house, *motel*, *hotel*, or other dwelling fails to pay rent that has become due and delinquent, within twenty days after delivery of written demand therefor . . . the lessee shall be liable for reasonable attorney fees . . .") (emphasis added).

Unfortunately, in 1985 the Louisiana Supreme Court held in *Pioneer Bank & Trust Co. v. Oechsner*, 468 So. 2d 1164 (La. 1985), that hotel room revenues were not "rent." The issue in *Oechsner* was whether the mortgagee of a New Orleans motel could obtain sequestration of room receipts under LA. CODE CIV. PROC. ANN. art. 327, which permitted the sheriff to collect "rents" and "revenues" of property that had been seized. The owner argued that hotel room receipts were not "rents" or "revenues" of the hotel and thus could not be seized. *Oechsner*, 468 So. 2d at 1166-67. The court held that the receipts were "revenues" subject to seizure, *id.* at 1168, but in a manner shockingly typical of more recent hotel bankruptcy cases, the court held that the receipts were not rents because hotel guests were not tenants. *Id.*; *see also In re T-H New Orleans Ltd. Partnership*, 148 B.R. 456, 460 (E.D. La. 1992) (citing *Oechsner* as authority).

This aspect of *Oechsner* seems plainly wrong. In support of its distinction between hotel guests and tenants, the court cited only two decisions, *Walling v. Peavy-Wilson Lumber Co.*, 49 F. Supp. 846 (W.D. La. 1943), and *Coggins v. Gregorio*, 97 F.2d 948 (10th Cir. 1938). *Coggins* was a tort action brought by a New Mexico tenant against a New Mexico landlord for damages caused by falling plaster. *Coggins*, 97 F.2d at 949-50. *Walling* was an action by the United States Department of Labor against a Louisiana-based company to enjoin violations of the Fair Labor Standards Act at its plant in Holopaw, Florida, where it provided lodging to company employees at excessive "rental" costs. *Walling*, 49 F. Supp. at 853-58. As New Mexico and Florida are common law states, these cases are completely inapposite. The court's characterization of hotel room receipts seems contrary to the Louisiana Civil Code and other civil codes which either explicitly or implicitly treat hotel room receipts as rent. *See, e.g.*, LA. CIV. CODE ANN. art. 2669 (West 1952) (treating *any* contract by which one party gives another "the enjoyment of a thing" as a lease for rent); ITALIAN C.C. § 2760 ("Claims

2. Common Law Judicial Treatment as "Rent" of Sums Paid Outside the Context of the Landlord-Tenant Relationship (Herein of Oil and Gas Lessees and Lodgers)

Even within the common law tradition, courts have characterized payments made for the use of land as "rent" even though those payments are not made by tenants who possess a nonfreehold estate in land. The following sections highlight two examples of this broader conception of rent—the consistent judicial treatment of oil and gas revenues as "rent," and the tendency of courts generally to classify the payment obligations of lodgers as "rent."

*a. Treatment of Revenues from Oil and Gas Leasing as "Rent"*

A large number of petroleum-producing states recognize absolute ownership of oil and gas in place beneath the earth's surface. In these states ("ownership theory" states), an owner of land "owns" the oil and gas located beneath the land by virtue of her ownership of the land surface.<sup>119</sup> Other states, however, do not recognize absolute ownership of oil and gas in place. In these states ("nonownership theory" states), the surface owner does not own oil and gas located beneath the surface, but merely owns an exclusive right to search for oil and gas on that land. The surface owner cannot acquire ownership of the oil and gas itself until she removes it from the ground and reduces it to her possession.<sup>120</sup>

A surface owner may transfer her rights respecting oil and gas beneath the surface through a conveyance typically called an oil and gas "lease." In a nonownership theory state, where the surface owner has no possessory rights in oil and gas in place, the lessee

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of innkeepers for rent . . . have a privilege on the property brought by the guests into the inn or its appurtenances . . .").

This mistake has significant consequences in the bankruptcy context. *Oechsner* did hold that hotel room receipts are "revenues" because they are "like rent, paid for the use of the property." *Oechsner*, 468 So. 2d at 1168. Accordingly, for purposes of creating and perfecting a security interest in hotel room revenues in Louisiana, hotel room revenues are treated like rents. But since the *Oechsner* court transplanted erroneous common law conceptions into its analysis, Louisiana hotel mortgagees can still fall victim to the Bankruptcy Code § 552(a) trap. See *In re T-H New Orleans Ltd. Partnership*, 148 B.R. 456, 460-63 (E.D. La. 1992) (mortgagee's lien against postpetition "revenues" extinguished by Bankruptcy Code Section 552(a)).

119. RICHARD W. HEMINGWAY, *THE LAW OF OIL AND GAS* § 1.3, at 29 & n.131 (3d ed. 1991).

120. *Id.* § 1.3, at 29 & n.132.



receives no common law estate in land.<sup>121</sup> As such, this "leasing" relationship is not one of landlord and tenant. The lessor's conveyance merely transfers to the lessee the right to search for and remove any oil and gas located under the land, a right which the common law has classified as a *profit à prendre*.<sup>122</sup>

In exchange for her interest, the lessee agrees to pay certain sums called "delay rentals," payments made in order to delay commencement of development operations.<sup>123</sup> The lessee also agrees to pay to the lessor a royalty out of future production under the lease.<sup>124</sup> In ownership theory states, courts have treated delay rentals and royalties as rent in the nature of realty, or so analogous to rent as to partake of its character.<sup>125</sup> Such treatment presents no conceptual problem, as the lessee receives a possessory interest in oil and gas in place, and the delay rentals and royalties constitute a return upon that interest. In nonownership theory states, however, the lessee's mineral interest is *incorporeal*.<sup>126</sup> If Tiffany and other scholars were correct to suggest that rent cannot issue upon the

121. *Id.* § 1.3, at 32-33; see also JOHN S. LOWE, OIL AND GAS LAW IN A NUTSHELL 32 (1988) ("By definition, no owner of any oil and gas right can have the right to present possession of the oil and gas in place in a non-ownership theory state.").

122. HEMINGWAY, *supra* note 119, § 1.3, at 33. Numerous modern cases in non-ownership theory states are in agreement. See *Pasteur v. Niswanger*, 290 S.W.2d 852, 853 (Ark. 1956); *Davis v. Collins*, 245 S.W.2d 571, 572 (Ark. 1952); *Atlantic Oil Co. v. County of L.A.*, 446 P.2d 1006, 1011 (Cal. 1968); *Gerhard v. Stephens*, 442 P.2d 692, 704-05 (Cal. 1968); *Miller v. Ridgley*, 117 N.E.2d 759, 761 (Ill. 1954); *Rice Brothers Mineral Corp. v. Talbott*, 717 S.W.2d 515, 516-17 (Ky. Ct. App. 1986); *Voyta v. Clonts*, 328 P.2d 655, 659 (Mont. 1958); *Williard v. Federal Sur. Co.*, 8 P.2d 633, 635 (Mont. 1932); *Boatman v. Andre*, 12 P.2d 370, 373 (Wyo. 1932); see also *Heller v. Dailey*, 63 N.E. 490, 493 (Ind. Ct. App. 1902) (lessee's interest in the nature of an incorporeal hereditament); *White v. McVey*, 31 P.2d 850, 851 (Okla. 1934) (same); *Walla Walla Oil, Gas & Pipeline Co. v. Vallentine*, 174 P. 980, 981 (Wash. 1918) (lessee has license in nature of incorporeal hereditament). Kansas courts have characterized the lessee's interest both as a license and a *profit à prendre* within the same case. See, e.g., *State ex rel. Fatzer v. Board of Regents*, 269 P.2d 425, 433 (Kan. 1954) ("An oil and gas lease . . . conveys no interest in land, but is merely a license to explore . . . . Such a lease is a '*profit à prendre*.'") (citations omitted).

123. HEMINGWAY, *supra* note 119, § 2.3, at 54; W.L. SUMMERS, THE LAW OF OIL AND GAS § 571, at 3 (1958).

124. HEMINGWAY, *supra* note 119, § 2.5, at 57-58.

125. E.g., *id.* § 2.3, at 55 (delay rentals); *id.* § 2.5(B), at 59-60 (royalties); see also *Commissioner v. Wilson*, 76 F.2d 766, 769 (5th Cir. 1935) (delay rentals); *Merrill Eng'g Co. v. Capitol Nat'l Bank*, 5 So. 2d 666, 670 (Miss. 1942) (royalty); *Texas Co. v. Parks*, 247 S.W.2d 179, 184 (Tex. Civ. App. 1952) (delay rentals); *Caruthers v. Leonard*, 254 S.W. 779, 782-83 (Tex. Com. App. 1923) (delay rentals); cf. *Kentucky Bank & Trust Co. v. Ashland Oil & Transp. Co.*, 310 S.W.2d 287, 290 (Ky. 1958) (royalty is incorporeal hereditament in nature of realty); *Duquesne Natural Gas Co. v. Fefolt*, 198 A.2d 608, 610 (Pa. Super. Ct. 1964) (same).

126. See *supra* note 120 and accompanying text.

conveyance of an incorporeal interest,<sup>127</sup> then delay rentals or royalties could not constitute "rent" in nonownership theory states. Yet courts have characterized these obligations as rent in the nature of realty, consistent with the broader historical scope of the term.<sup>128</sup> As the California Supreme Court has recognized:

"Rent is a compensation paid for the use of land. . . ." Similarly, royalty payments are consideration to the lessor for the uses of land allowed by contract. "Under the usual oil and gas lease the owner confers on the lessee for the term of the lease an exclusive right of profit to drill for and produce oil, the lessee usually returning to the lessor for the privilege granted a *rent or royalty* measured by a fraction of the oil produced." . . . [W]e recognized that "royalty return . . . is rent, or so closely analogous to rent as to partake of the incidents thereof." "*The words 'royalty' and 'rent' . . . 'are used interchangeably to convey the same meaning,' i.e., 'the compensation which the occupier pays the [lessor] for that species of occupation which the contract between them allows.'*"<sup>129</sup>

#### *b. Lodgers and Holders of Licenses to Occupy Land*

The hotel bankruptcy cases have concluded that the holder of a license to occupy land does not pay rent because she has no "interest in the realty to which the license obtains."<sup>130</sup> While the hotel

127. See, e.g., 2 BLACKSTONE, *supra* note 77, at \*41 (rent "cannot be reserved out of an advowson, a common, an office, a franchise, or the like") (footnote omitted); 3 JAMES KENT, COMMENTARIES ON AMERICAN LAW 657 (Charles M. Barnes ed., 13th ed. 1884) (rent "cannot issue out of a mere privilege or easement"); 1 TIFFANY, *supra* note 56, § 169, at 1019-20 (common law rent was incorporeal interest that issued only out of corporeal tenements). Many scholars cited Lord Coke in support of this position, but Coke himself confined the rule only to "common persons," not to the King. COKE, *supra* note 71, Bk. 1, Ch. 7, § 58, at 47a. Coke noted that the King could "reserve rent out of an incorporeal inheritance; the reason of which is, that he by his prerogative can distrain on all the lands of his lessee." *Id.* Bk. 1, Ch. 7, § 58, at 47a n.284.

128. See, e.g., *Arrington v. United Royalty Co.*, 65 S.W.2d 36, 37-38 (Ark. 1933); *Atlantic Oil Co. v. County of L.A.*, 446 P.2d 1006, 1015 (Cal. 1968); *Dabney-Johnston Oil Corp. v. Walden*, 52 P.2d 237, 244 (Cal. 1935); *Callahan v. Martin*, 43 P.2d 788, 795 (Cal. 1935); see also HEMINGWAY, *supra* note 119, § 2.3, at 55 ("It would seem a better view, however, to apply a broader concept of rent as including any 'income, return, or profit' arising out of the land. Under this view delay rentals would constitute rent."). *But see* *Lathrop v. Eyestone*, 227 P.2d 136, 141 (Kan. 1951) (delay rental and royalty characterized as personalty); *Pure Oil Co. v. Kindall*, 156 N.E. 119, 122-23 (Ohio 1927) (though "royalty" and "rentals" are used interchangeably, royalty is personalty).

129. *Atlantic Oil Co.*, 446 P.2d at 1015 (emphasis added) (citations omitted) (quoting *Dabney-Johnston Oil Corp. v. Walden*, 52 P.2d 237, 243 (Cal. 1935); *Nelson v. Republic Iron & Steel Co.*, 240 F. 285, 291-93 (8th Cir. 1917); *Callahan v. Martin*, 43 P.2d 788, 795 (Cal. 1935); *Clarke v. Cobb*, 59 P. 74, 75 (Cal. 1898)).

130. *In re Nendels-Medford Joint Venture*, 127 B.R. 658, 663 (Bankr. D. Or. 1991).

guest does not have a nonfreehold estate in her assigned room,<sup>131</sup> that is not the same as saying that she has no interest in the room *at all*. The blanket conclusion that a license to occupy land does not constitute an "interest in land" fails to recognize that the term "interest"—like the term "possession"—is a relative term not always synonymous with "estate."

A license to occupy land is only a contract, and the holder of a license has a tenuous interest that is generally unprotected by a possessory remedy.<sup>132</sup> While this lack of a possessory remedy has caused many courts to conclude that a license does not constitute an interest in land,<sup>133</sup> that conclusion inextricably fuses the occupier's rights and remedies, rendering the meaning of "interest" static regardless of context. The drafters of the *Restatement of Property* rejected this approach, defining the term "license" as an "interest in land"<sup>134</sup> and thus squarely embracing the notion that the term "interest" has meaning that is not absolute, but relative depending

131. See *supra* notes 24–25 and accompanying text.

132. The licensee's interest, however, is not appreciably more tenuous than that of the early common law lessee. See *supra* notes 67–76 and accompanying text. This raises another question—when was there a conceptual need for the license as a legal interest respecting land? As Clark noted, early common law recognized no defined legal interest termed "license." CHARLES E. CLARK, REAL COVENANTS AND OTHER INTERESTS WHICH "RUN WITH LAND" 18–19 n.17 (2d ed. 1947) (noting that earliest apparent case distinguishing "license" from gift, grant, or lease was decided in 1461). Before the common law accorded the lessee with possessory remedies, the common law and civil law leasing transactions were identical, each involving purely in personam rights. As in the civil law tradition, the common law had no conceptual need for an interest analogous to the modern license to occupy the land of another. *Id.* ("In the Roman or civil law there seems to be no defined legal interest of this character [the license], there being no lesser *iura in re aliena* than servitudes, which like our easements are indestructible by the owner of the land owing the obligation."). Once the common law began to accord the lessee with possessory remedies, however, some interest analogous to the modern "license" was needed to create a purely in personam right to occupy the land of another.

133. See, e.g., *Wheeler v. West*, 11 P. 871, 873 (Cal. 1886); *Eastman v. Piper*, 229 P. 1002, 1004 (Cal. Dist Ct. App. 1924); *Tucker v. Carter Oil Co.*, 43 N.E.2d 99, 101 (Ill. App. Ct. 1942); *Parish v. Caspar*, 10 N.E. 109, 110 (Ind. 1887); *Kuhlman v. Rivera*, 701 P.2d 982, 985 (Mont. 1985); *Waterville Estates Ass'n v. Town of Campton*, 446 A.2d 1167, 1169 (N.H. 1982); *Hill v. Smith*, 277 S.E.2d 542, 545 (N.C. Ct. App. 1981). A number of these cases turn upon the fact that the license was an oral agreement. See, e.g., *Wheeler*, 11 P. at 873; *Tucker*, 43 N.E.2d at 101. As the court noted in *Wheeler*, had the license been in writing, it would have created "an incorporeal hereditament," clearly an interest in land. *Wheeler*, 11 P. at 873.

134. Section 512 defines "license" as "an interest in land in the possession of another which (a) entitles the owner of the interest to a use of the land, and (b) arises from the consent of the one whose interest in the land used is affected thereby, and (c) is not incident to an estate in the land, and (d) is not an easement." RESTATEMENT OF PROPERTY § 512 (1944); see also *id.* cmt. c ("All 'licenses' . . . are 'interests in land' as that phrase is used in the Restatement of Property.").

upon context. A license to occupy land is not equivalent to an estate in land, and thus is not an "interest in land" for the purpose of the statute of frauds.<sup>135</sup> For other purposes, however, the law deems the licensee to have a sufficient "interest in land" to sustain the licensee's continued exercise of the license despite the licensor's attempted revocation.<sup>136</sup> Furthermore, factual context may justify a conclusion that a licensee has a relative "possessory" interest—one that is not possessory as against the licensor, but that is possessory as against third persons.<sup>137</sup> For as long as a license to occupy

135. *Id.* § 512 cmt. c.

136. In theory, a license is revocable at the will of the licensor, *id.* §§ 519(1), 521(1), but when context requires, courts have riddled this principle with caveats. *See, e.g.*, *Cooke v. Ramponi*, 239 P.2d 638, 640-42 (Cal. 1952) (licensee spent sums to build access road across land of licensor; licensor cannot revoke); *Stoner v. Zucker*, 83 P. 808, 809-10 (Cal. 1906) (licensee constructed irrigation ditch across land of licensor; licensor cannot revoke); *Verrall v. Great Yarmouth Borough Council*, 1981 Q.B. 202, 209, 216 (Eng. C.A.) (owner agreed to allow National Front to use meeting hall for two-day conference but later revoked consent; National Front granted specific performance of license agreement); RESTATEMENT OF PROPERTY § 519(4) (1944) (licensee who expends capital or labor in reasonable reliance upon representations as to license's duration may continue use after revocation to extent reasonably necessary to recover expenditures). When a license is deemed irrevocable by its nature or by context, it is functionally equivalent to an easement (or in the case of a license to occupy land, a lease), and its status as a bona fide interest in land seems beyond dispute.

Furthermore, English courts have held that certain licensees can have "exclusive possession" even against the licensor. *Street v. Mountford*, 1985 App. Cas. 809, 818 ("There can be no tenancy unless the occupier enjoys exclusive possession; but an occupier who enjoys exclusive possession is not necessarily a tenant. He may be . . . an object of charity or a service occupier."); *see also Heslop v. Burns* [1974] 1 W.L.R. 1241, 1252 (Eng.) ("The fact of the exclusive occupation of property for an indefinite period is no longer inconsistent with the occupier being a licensee and not a tenant at will.").

137. Conceptually, the revocable nature of a license does not mean that a licensee must possess no remedies against third party interference. CLARK, *supra* note 132, at 28. As the drafters of the *Restatement* argued:

The physical relationship to land and the intent to control it sufficient to entitle the one having such relationship and such intent to protection as a possessor of the land vary . . . in different personal relationships. . . . Specifically, a relationship to land sufficient to entitle the one having it to protection as a possessor as against third persons may not entitle him to such protection as against the owner of the land. . . . Interests which are less than possessory as against the owner of the land may be possessory as against third persons. *Interests which do not amount to leases as against the owner of the land, which are as against him only licenses, may be the equivalent of leases as against third persons.*

RESTATEMENT OF PROPERTY § 521(2) cmt. b (1944) (emphasis added). This comment has been criticized, but it seems a rather straightforward application of the principle of relativity of title, a principle that by now should be beyond reproach. Consistent with this approach, courts have acted where appropriate to protect licensees against interference. *See Water Works & Sewer Bd. v. Anderson*, 530 So. 2d 193, 196-98 (Ala. 1988) (upholding TRO preventing licensor from logging land); *Patterson v. Shoffner Sand*,

land continues, the licensee's right of occupation "derogates from the completeness of the servient owner's ownership and this requires [the license's] recognition as an 'interest in land.'" <sup>138</sup>

By acknowledging that the holder of a license to occupy land possesses an interest in land (albeit not one that is "possessory" for all purposes or against all persons), one can denominate the licensee's payment obligation as "rent," <sup>139</sup> as numerous courts have done when the licensee at issue was a lodger. <sup>140</sup> Like all licensees, the lodger has only a contractual right to use and occupy some portion of the land of another, unprotected by a possessory remedy. <sup>141</sup> Yet the lack of a possessory remedy has no necessary

Inc., 530 P.2d 580, 583-84 (Okla. Ct. App. 1974) (licensee with right to remove sand could enjoin licensor's tenant from interfering with sand removal); *Moundsville Water Co. v. Moundsville Sand Co.*, 19 S.E.2d 217, 218-20 (W. Va. 1942) (holder of license to pipe water across sand company's land could enjoin sand company's actions that interfered with piping of water); see also *Nahas v. Local 905, Retail Clerks Int'l Ass'n*, 302 P.2d 829, 830 (Cal. Dist. Ct. App. 1956) (suggesting in dictum that licensee may enjoin violation of right to exercise license); *Bell Tel. Co. v. Baltimore & Ohio R.R. Co.*, 38 A.2d 732, 733 (Pa. Super. Ct. 1944) (same).

138. RICHARD R. POWELL & PATRICK J. ROHAN, *POWELL ON REAL PROPERTY* ¶ 428, at 584 (1968).

139. Two illustrative examples in the Restatement use the term "rent" or "rental" to describe payments made in exchange for licenses in land. See *RESTATEMENT OF PROPERTY* § 519(4) cmt. g, illus. 3 (1944) (demand by owner of land subject to license that licensee pay "rental" for permission to maintain power transmission lines); *id.* § 521(4) cmt. e, illus. 2 (oral agreement to mine land of another in exchange for "rent" of proportion of gross income from mining operations).

140. See *infra* notes 142-147 and accompanying text.

141. While the hotel bankruptcy cases focus on the guest's lack of exclusive "possession," English courts have designated certain of the lodger's/guest's constituent rights as "exclusive." See Stephen Tromans, *Leases and Licences in the Lords*, 44 *CAMBRIDGE L.J.* 351, 353 (1985) ("The lodger, it should be carefully noted, may be entitled to exclusive *occupation*. He may under the terms of his contract be entitled to insist on no-one else occupying with him (even the owner). What he cannot do is exclude the owner entirely, by an action for trespass if necessary. That is the prerogative of the tenant."); *Allan v. Overseers of Liverpool*, [1874] 9 *L.R.-Q.B.* 180, 191-92 (Eng.) (Blackburn, J.) (lodger has exclusive use of room even though not in exclusive possession against landlord).

Several American decisions also have characterized certain rights of lodgers or hotel guests as "exclusive," despite the lack of a possessory remedy. See, e.g., *Frewen v. Page*, 131 N.E. 475, 476 (Mass. 1921) ("[H]aving duly registered and been put in possession of a room for their exclusive use, [guests] had the right of occupation for all lawful purposes until vacated . . ."); *Holly v. Meyers Hotel & Tavern*, 83 A.2d 460, 463 (N.J. Super. Ct. App. Div. 1951) ("When a guest is given the key to his room, it symbolizes the surrender of the quarters to the guest . . . [T]he guest is entitled to possess the free and unmolested use and enjoyment of his room or apartment without interference from anyone."); *rev'd on other grounds*, 89 A.2d 6 (N.J. 1952); *De Wolf v. Ford*, 86 N.E. 527, 530 (N.Y. 1908) ("[T]he guest also has affirmative rights which the innkeeper is not at liberty to willfully ignore or violate. When a guest is assigned to a room for his exclusive use, it is his for all proper purposes, and at all times, until he

consequence for classifying the lodger's payment obligation. As the House of Lords recognized in its landmark 1985 decision, *Street v. Mountford*,<sup>142</sup> the lodger's contractual rights of use and occupation of the land form a basis for characterizing the lodger's obligation as rent:

An occupier of residential accommodation at a rent for a term is either a lodger or a tenant. The occupier is a lodger if the landlord provides attendance or services which require the landlord or his servants to exercise unrestricted access to and use of the premises.<sup>143</sup>

This conception also finds support in the propensity of American judicial decisionmakers to characterize the income paid by lodgers or hotel guests as "rent." Numerous American courts, in resolving disputes between owners of hotels<sup>144</sup> or roominghouses<sup>145</sup> and their

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gives it up."); *Wolk v. Pittsburgh Hotels Co.*, 131 A. 537, 539 (Pa. 1925) ("[T]he guest or boarder has an absolute right to the free enjoyment of his room or apartment, without interference from anyone."); see also RESTATEMENT (THIRD), *supra* note 13, § 4.2 reporter's note, at 80 ("[A] hotel guest not only has the right to occupy the building space for a delineated period, but he or she also has the right to exclude others, including, in many situations, the hotel management.").

142. 1985 App. Cas. 809. In this case, Street granted Mountford a right to occupy a furnished room at £37 per week pursuant to an agreement called a "licence." *Id.* at 814-15. When Street tried to evict Mountford, Mountford asserted that she was a tenant entitled to the protections of the Rent Act (which protects tenants but not licensees). The case attracted great interest because a ruling for Street would have indicated that landlords could avoid the effects of the Rent Act by characterizing their occupancy agreements as licenses. The House of Lords ruled that under the agreement, Mountford was in fact a tenant and was thus entitled to the benefit of the Rent Act. *Id.* at 827.

143. *Id.* at 817-18.

144. See, e.g., *Johnson v. Riverside Hotel, Inc.*, 399 F. Supp. 1138, 1139-41 (S.D. Fla. 1975) (obligation of transient guest characterized as "rent"); *Collins v. Viceroy Hotel Corp.*, 338 F. Supp. 390, 392 & n.2 (N.D. Ill. 1972) (court denominates weekly obligation of hotel guest as "rental" and "rent"); *Green v. Watson*, 36 Cal. Rptr. 362, 365 (Dist. Ct. App. 1964) (characterizing both tenants and lodgers as "renting" rooms); *Sloan v. Court Hotel*, 164 P.2d 516, 520-21 (Cal. Dist. Ct. App. 1945) (hotel owner's acceptance of "rent" from plaintiff supported inference of implied contract to accept plaintiff as roomer); *Roberts v. Casey*, 93 P.2d 654, 656-60 (Cal. App. Dep't Super. Ct. 1939) (characterizing obligation of apartment hotel occupier as "rent"); *Davis v. Brinkhouse Hotel Co.*, 219 P. 1074, 1074 (Colo. 1923) (innkeeper's acceptance of one month's "rent" from guest did not waive lien for balance of unpaid rent); *Bourque v. Morris*, 460 A.2d 1251, 1252-54 (Conn. 1983) (guest's contract for occupation of hotel room was for transient occupancy, despite "fact that the rent was paid weekly"); *Davis v. Francis Scott Key Apartments*, 140 A.2d 188, 189 (D.C. 1958) (resident of apartment hotel characterized as roomer but described as having "rented" room); *Ortner v. Linch*, 128 So. 2d 152, 155 (Fla. Dist. Ct. App. 1960), *cert. denied*, 138 So. 2d 340 (Fla. 1961) (invitee status of hotel guest "not dependent upon whether the rent is fixed by the day, by the month, or by the year"); *Zappa v. Higgins*, 156 S.E.2d 521, 521 (Ga. Ct. App. 1967) (suit by hotel owner to recover for "rental" of room to temporary guest); *Marden v. Radford*, 84 S.W.2d 947, 959 (Mo. Ct. App. 1935) (owner's "billing of the rent" for hotel room raised inference that plaintiff occupier was lodger, not tenant); *Landry v.*

guests, have denominated the sums paid by the guests as "rent" even though the guests are mere licensees.<sup>146</sup>

### 3. Summary

In its proper historical scope, rent is "the compensation which the occupier [of land] pays . . . for that species of occupation which the contract between them allows."<sup>147</sup> The bankruptcy courts' for-

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Allerton N.Y. Corp., 83 N.Y.S.2d 774, 775 (Sup. Ct. 1948) (in statement of facts, court denominates guest's obligation as "rent"); *Roth v. Hotel Riverside Plaza, Inc.*, 67 N.Y.S.2d 518, 519 (Sup. Ct. 1947) (same); *New S. Hotel Co. v. Kingston*, 72 N.E.2d 782, 785 (Ohio Ct. App. 1936) (noting that agreement of long-term guest was "for a rental of the room for month to month"); *Lyons v. Kamhoot*, 575 P.2d 1389, 1390-91 (Or. 1978) (in statement of facts, court notes that rooms in residential hotel are "rented" to temporary guests); *McIntosh v. Schops*, 180 P. 593, 595 (Or. 1919) (two-year resident of hotel at "rental" of twelve dollars per month held to be boarder, not tenant). Even a few hotel bankruptcy cases have acknowledged that hotel room revenues have the characteristics of rent. See *In re Northview Corp.*, 130 B.R. 543, 548 (Bankr. 9th Cir. 1991) (though paid by licensees, hotel revenues "are closest in kind to 'rents,' since they are generated by the hotels' provision of room rentals and related services"); see also *In re Kearney Hotel Partners*, 92 B.R. 95, 99 (Bankr. S.D.N.Y. 1988) (noting that hotel revenues are "referred to in common parlance as 'rent'").

145. See, e.g., *McDonnell v. Solomon*, 170 P. 951, 951-52 (Colo. 1918) (repeatedly characterizing obligation of roominghouse occupant as "rent"); *Carroll v. Cooney*, 163 A. 599, 600 (Conn. 1933) (lodginghouse owner had lien upon lodger's goods for unpaid rent); *Mathews v. Livingston*, 85 A. 529, 531 (Conn. 1912) (same); *Thomas v. Lenhart*, 444 A.2d 246, 247-49 (Conn. Super. Ct. 1982) (characterizing agreement for occupation of lodginghouse as "rental agreement"); *Lindsey v. Watson*, 83 A.2d 226, 227 (D.C. 1951) (stating that roominghouse owner received "rent" from plaintiff roomer); *Tamamian v. Gabbard*, 55 A.2d 513, 513-16 (D.C. 1947) (repeatedly characterizing obligation of roomer as "rent"); *Donlin v. Pierce*, 133 So. 178, 178-79 (La. Ct. App. 1931) (same); *Trout v. Tipton*, 145 N.E.2d 478, 479-80 (Ohio Ct. App. 1956) (same).

146. Typical of these decisions is *Roberts v. Casey*, 93 P.2d 654 (Cal. App. Dep't Super. Ct. 1939). The Roberts owned the Riviera Apartment Hotel in San Diego, in which they offered "for rent" furnished rooms and apartments by the day, week, or month. *Id.* at 656. The Roberts retained keys to all rooms, and provided housekeeping services typical of hotels. The Roberts sued to evict Casey, an occupant who was delinquent in payment of his room charges.

In its decision, the court in *Roberts* stated that an owner and her licensee guest could stand in a relationship that involved the letting of property without actually being landlord and tenant. While holding that Casey was a "mere guest or lodger" not entitled to a tenant's possessory remedies, the court suggested that Roberts and Casey were lessor and lessee, and called Casey's obligation "rent." *Id.* at 657 ("Ordinarily the landlord furnishes the lodger with a furnished room or rooms, whose care the landlord has, and whose habitation and enjoyment he gives to the lodger, while he himself retains the occupation. The tenant has the exclusive possession of his rooms, while the lodger has merely the use without the actual or exclusive possession which remain in the lessor.") (quoting *Mathews v. Livingston*, 85 A. 529, 531 (Conn. 1912)); see also *id.* at 660 (noting that Roberts had elected to oust Casey on January 23, such that Roberts could not "claim rent for the final eight days of that month").

147. *Atlantic Oil Co. v. County of L.A.*, 446 P.2d 1006, 1015 (Cal. 1968) (quoting *Nelson v. Republic Iron & Steel Co.*, 240 F. 285, 293 (8th Cir. 1917)); see also, HAROLD

malistic definitions of "possession" and "interest in land" narrow the legal scope of the term "rent" and fail to acknowledge that the terms "possession" and "interest in land" are relative terms whose meaning varies with context. As the proposed *Restatement* recognizes, parties can contract for the limited use and occupation of land without standing in a relationship of landlord and tenant (accompanied by its attendant feudal limitations). Thus, one can properly characterize the payment obligation of the hotel guest or other holder of a license to occupy land as "rent," as the Kansas and North Carolina legislatures have made explicit by recent amendments.<sup>148</sup> Accordingly, the proposed *Restatement's* position treating the income paid by occupier-licensees as "rent" is legally sound, and bankruptcy courts should embrace the proposed *Restatement* in administering distressed hotels and similar commercial real estate developments.

### III. COMMERCIAL POLICY AND "RENTS" WITHIN THE STRUCTURE OF THE COMMERCIAL REAL ESTATE FINANCING TRANSACTION

If the "practical context in which the question of lease or license is raised must never be overlooked,"<sup>149</sup> then the question of how security law should denominate the income paid by occupiers of a commercial land development must be informed by the context of the commercial real estate mortgage transaction. Courts cannot appreciate that the drafters of the proposed *Restatement* are correct to treat hotel room revenues as "rents" if those courts fail to consider and understand the structure of the hotel mortgage transaction as compared with other commercial real estate mortgage transactions. As Part III demonstrates, these financing transactions are economically similar, and sound policy suggests that security law should treat the parties to these transactions in a similar fashion.

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F. LUSK & WILLIAM B. FRENCH, *LAW OF THE REAL ESTATE BUSINESS* 398 (3d ed. 1975) ("Rent is the consideration paid for the use and occupation of property."); Stone, *supra* note 111, at 348 ("rent [is] that which one person renders to another in return for the use of his land").

148. See KAN. STAT. ANN. § 58-2343(a)(4) (Supp. 1992) (" 'Rents' includes the rents, income, proceeds, profits, royalties and other sums which are (A) derived under present and future leases, licenses, contracts and other agreements for the use of possession of real property . . . ."); N.C. GEN. STAT. § 47-20(b)(1) (Supp. 1992) (" 'Rents, issues, or profits' means . . . all amounts payable by or on behalf of any licensee or permittee or other person occupying or using real property under license or permission from the owner or person entitled to possession.").

149. RABIN & KWALL, *supra* note 23, at 27.



Several bankruptcy courts have justified their decisions to extinguish liens upon postpetition hotel revenues by arguing that sound commercial policy requires that hotel room revenues be classified differently from real property "rents" when used as collateral. The decision of the United States Bankruptcy Court for the District of Oregon in *In re Nendels-Medford Joint Venture*<sup>150</sup> illustrates this reasoning. In *Nendels-Medford*, the court rejected the mortgagee's argument that postpetition room revenues were "rents and profits" in the nature of land and articulated the policy concerns underlying this result:

To the extent that [the mortgagee argues] for the proposition that "rents, issues, and profits" clauses or any other more imaginative version thereof which appear in real property security instruments, may secure income arising from the operation of a business on the premises, this court believes it to be contrary to the interests of the financial and legal community. . . . If the language used [by the mortgagee's instruments] is broad enough to cover revenue from all motor inn business, it must also be broad enough when used by other creditors to cover revenues from *any* wholesale or retail business housed on real estate. Yet such income is largely generated from personal property and any security interests therein are universally recognized to be governed by Article 9. What the financial and legal community deserve is a legal interpretation for clauses which appear in collateral assignment documents that is not overly broad, is relatively precise, and supports a clear distinction between what is to be collaterally secured under the provisions of Article 9 and what is to be collaterally secured under the state land recording system.<sup>151</sup>

There can be little doubt that these policy objectives are desirable. No one desires uncertainty in the law governing commercial relationships involving property.<sup>152</sup> Yet the need for transactional certainty does not justify wholesale judicial abandonment of economic substance in favor of legal formalism.<sup>153</sup> If the economic assump-

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150. 127 B.R. 658 (Bankr. D. Or. 1991).

151. *Id.* at 667.

152. Except perhaps law professors, who can use uncertainties as teaching tools in classrooms devoid of transaction costs.

153. As Professor John Dewar has noted, courts relying upon conceptual formalism often attempt to articulate narrow policy justifications in support of some "conceptually-dictated" result, relying upon the premise that such a result will make the law more certain. Dewar, *supra* note 58, at 742 ("Above all, conceptual formalism is characterized by the assumption that conceptual problems need conceptual resolution in a way that renders the law more 'certain.'"). And as Grant Gilmore noted, in few areas of law does formalism have as extensive a pedigree as in security law. Grant Gilmore, *Security Law, Formalism and Article 9*, 47 NEB. L. REV. 659, 660-61 (1968) (discussing tendency of courts toward extreme rigidity in interpreting the parameters of approved security devices).

tions underlying a court's use of formalism are incorrect, the court's objective of achieving certainty is certain to be frustrated.

This is apparent in the hotel bankruptcy cases. The manner in which bankruptcy courts have invoked the policy concern for "certainty" reflects a misunderstanding of the nature of commercial mortgage financing. Implicit in the *Nendels-Medford* court's policy analysis is the premise that running an apartment complex (which generates "rent") is so fundamentally different from running Macy's that the income generated by each must constitute different forms of collateral. Even if the premise is correct,<sup>154</sup> it is beside the point, for it altogether fails to consider the structure of the underlying mortgage financing contract. No sound policy requires that the legal relationship between a hotel owner and its guest must control the construction of the hotel's financing documents, which reflect the legal relationship between the hotel owner and the mortgagee (and to which the guest is not a party). As discussed below, hotel financing shares similar development and underwriting assumptions with apartment, shopping center, and office building financing. Sound commercial policy accordingly dictates that security law should treat the hotel financing transaction in the same fashion as "tenant-based" projects.

A. *Acknowledging the Economic Identity of Commercial Real Estate Mortgage Financing Transactions*

In terms of economic reality, mortgage financing transactions involving hotels and mortgage financing transactions involving apartment complexes (or some other project in which the occupants are tenants) are identical. No commercial real estate development is "typical"; the universe of potential projects is limited only by market forces and the imagination of creative developers. As long as there is sufficient demand for a particular commercial end use of land, some developer will locate a suitable parcel of land and attempt to create a "unique" project to exploit that demand.<sup>155</sup> Nevertheless, one can generalize about a typical commercial real estate project for two reasons. First, market forces have generated substantial numbers of projects that fall within identifiable categories

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154. Part IV argues that the term "rent" is no longer helpful in describing the sums generated by an income-producing real estate development, and that those sums should be classified in a manner that better reflects their true nature.

155. This is probably understated; the experience of the savings and loan crisis suggests that enterprising (or unscrupulous—reach your own value judgments!) developers will undertake commercial real estate exploitation even absent suitable market demand.

(such as apartments, offices, shopping centers, or hotels). Within each category, individual projects are architecturally unique and possess market advantages (or disadvantages) not possessed by other projects. In an economic sense, though, each project within each category is similar when viewed from the developer's decision-making perspective; while the Ritz-Carlton and the Motel 6 look very different to the business traveller, the financial statements that depict their respective room revenues look quite similar. Second, comparing projects from different categories (for example, comparing an apartment complex with a hotel) is not like comparing apples and oranges; the developmental and underwriting assumptions upon which any project is developed and financed are essentially the same.

In determining whether to acquire or develop income-producing real estate, the developer's financial analysis is essentially identical from transaction to transaction. While the process of real estate development involves many different areas of the law,<sup>156</sup> the initial development decision—whether the project is a “go” or a “no go”—is a financial decision largely free of other legal constraints. In determining whether to go forward with a proposed development, the developer does not care whether the income will be paid under commercial leases as opposed to licenses. The evaluation at this level is purely one of dollars and cents and economic feasibility. After a careful review of the physical amenities of the proposed project, the competitive market environment, local demand, and cost estimates for development and marketing, the developer projects a stream of revenues (composed of the consideration to be paid by the eventual occupiers of the land) over the useful life of the project.<sup>157</sup>

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156. [Real estate development implicates], in addition to the basic law of contracts and real property, such areas of the law as environmental matters, construction matters, insurance matters, marketing matters, engineering, architectural, zoning, tax, corporate, ERISA, securities, bankruptcy and creditors' rights. The list is almost endless.

Charles Zalaznick, *Introduction*, in REAL ESTATE DEVELOPMENT AND CONSTRUCTION FINANCING 1989, at 11 (PLI Real Estate Law Practice Course Handbook Series No. 325, 1989). See generally NORTON L. STEUBEN, REAL ESTATE PLANNING (2d ed. 1980).

157. See, e.g., STEPHEN A. PHYRR & JAMES R. COOPER, REAL ESTATE INVESTMENT 632–37 (1982); Thomas F. Morone, *Omni Hotels: Facility Acquisition and Developments, Hotel Feasibility Analysis—The Operations Perspective*, in FINANCING, DEVELOPMENT AND OPERATIONS OF HOTELS AND CASINOS, at 15 (PLI Real Estate Law Practice Course Handbook Series No. 332, 1989); Trevor C. Roberts, *Checklist for Purchasing Income Producing Property*, in REAL ESTATE DEVELOPMENT AND CONSTRUCTION FINANCING 1984, at 9 (PLI Real Estate Law Practice Course Handbook Series No. 248, 1984); Irwin Glick, *Economic Feasibility*, in FINANCING AND DEVEL-

If the projected cash flow exceeds the projected costs of operation and generates an acceptable return, the developer will attempt to proceed with the project. The threshold inquiry remains the same regardless of the type of project—is projected net cash flow from the project sufficient to provide a suitable return?<sup>158</sup>

Similarly, when the developer begins its search for financing, its prospective lenders are motivated by the same threshold economic concerns. The prudent lender's first inquiry is whether projected net cash flows will service the projected mortgage debt.<sup>159</sup> If the lender's appraisal and its review of the mortgage application indicate both that the developer's projections are trustworthy and that the discounted present value of the projected cash flows exceeds the desired principal loan balance (based on a prudent loan-to-value ratio and an appropriate discount rate to reflect market risk),<sup>160</sup> the lender will decide to finance the project. Thus, what

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OPMENT OF COMMERCIAL AND RESORT HOTELS, at 13 (PLI Real Estate Law Practice Course Handbook Series No. 188, 1981); Daniel S. Levy & Michael L. Steinberg, *Considerations Involved in the Purchase of an Existing Shopping Center*, in *EVALUATING REAL ESTATE AS AN INVESTMENT AND TAX SHELTER*, at 255 (PLI Real Estate Law Practice Course Handbook Series No. 165, 1979).

158. See Glick, *supra* note 157, at 27 (investor/developer should ask "Is the concept viable? Is this a good investment? Is it a good tax shelter? What will be the payout or return on equity?").

159. See *id.* at 28 (prospective lender asks "At what figure can the project be appraised? What mortgage value is warranted by appraised value? By prospective cash flow?"); see also MICHAEL T. MADISON & JEFFREY R. DWYER, *THE LAW OF REAL ESTATE FINANCING* ¶¶ 3.03–3.04, at 3-7 to 3-12 (1981); Gerald M. Levy, *Construction Loan Decision Making: Issues and Documents, Risks and Benefits*, in *REAL ESTATE DEVELOPMENT AND CONSTRUCTION FINANCING* 1990, at 125 (PLI Real Estate Law Practice Course Handbook Series No. 344, 1990).

160. MADISON & DWYER, *supra* note 159, ¶ 3.04[1], at 3-11 to 3-12; Paul M. Brady, *A Methodology for Underwriting Commercial Real Estate*, *REAL EST. REV.*, Winter 1990, at 58, 58–60 (accurately projected net operating income is key to determining proper loan amount); Steven R. Cole, *Estimating the Value of Proposed Developments by Discounting Cash Flow*, *REAL EST. REV.*, Summer 1988, at 32, 32–37; Lawrence E. Fiedler, *Calculating Residual Value in DCF Analysis*, *REAL EST. REV.*, Summer 1992, at 16, 17 ("The discounted cash flow (DCF) method . . . is also widely accepted for arriving at bid and ask prices for income-producing properties. Buyers and sellers are intuitively comfortable with the concepts behind discounting anticipated cash benefits back to present values."); Lawrence E. Fiedler & B. Hagen Saville, *The Misuse of DCF Analysis*, *REAL EST. REV.*, Spring 1992, at 18, 20–22 (noting that discounted cash flow method is "best available analytical technique for quantifying the elements of future cash flow," but cautioning that present value cannot be quantified by "mere extrapolation of historical variables"); Peter F. Korpacz & Mark I. Roth, *Changing Emphasis in Appraisal Techniques: The Transition to Discounted Cash Flow*, 51 *APPRAISAL J.* 24 (1983) (noting widespread acceptance of discounted cash flow analysis as the basis for pricing income-producing property); J. Douglas Timmons & Wayne R. Archer, *Discounted Cash Flow Analysis and Unpredictable Cash Flows*, *REAL EST. REV.*, Fall 1988, at 26, 26–30.

drives the project from proposal to reality is not whether state law would characterize the occupiers of the completed project as tenants or licensees or Grateful Dead fans; instead, it is projected cash flow. Unless projected cash flows are sufficient, the proposed development will not occur regardless of the legal characterization of the project's ultimate occupiers.

The significance of projected cash flows to the mortgage financing decision, and the understandings of both developer and mortgagee regarding those cash flows, are reflected clearly in the typical commercial mortgage loan documentation. Since the lender calculates its mortgage amount based upon projected cash flows, a lien upon those cash flows is necessary in order to provide adequate security for the mortgagee's position. Thus, "[t]o obtain a lien on the revenue, mortgage lending documents contain broad, sweeping, all-inclusive provisions covering every conceivable type of income, proceed, or revenue generated from the property."<sup>161</sup> By including the project cash flows within the collateral identified in the mortgage loan documents, the developer and the mortgagee demonstrate their unitary intention and understanding that those cash flows stand available for the satisfaction of the mortgage debt to the same extent as the underlying land itself.

The significance of projected cash flows to the transaction becomes even more compelling when the parties contemplate a nonrecourse loan transaction.<sup>162</sup> The theory underlying the nonrecourse transaction is a straightforward one of risk and return:

A developer puts certain assets at risk when he undertakes a project. If the project fails, that party will not be legally obligated to invest more money. If he chooses, he can walk away with impunity. Although he has lost his original investment, he has no personal liability and his other assets are not at risk. Other participants bear the downside risks of the project in exchange for benefits that make their liability worthwhile.<sup>163</sup>

When the parties to the commercial real estate mortgage financing transaction agree that the mortgagee will forgo recourse to the developer and instead accept recourse solely against the real estate and its income, they demonstrate an unmistakable intention that

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161. Averch, *supra* note 6, at 484.

162. Most commercial real estate mortgage loans (particularly those made to single-asset ownership entities) are made on a nonrecourse basis, with the mortgagee agreeing to take recourse only against the realty (and the income generated thereby) in the event of default. See Michael L. Molinaro, *Single-Asset Real Estate Bankruptcies: Curbing an Abuse of the Bankruptcy Process*, 24 UCC L.J. 161, 164 (1991).

163. Joshua Stein, *Nonrecourse Clauses Revisited*, REAL EST. REV., Summer 1992, at 26, 27.

the mortgagee have recourse to the project cash flows in accordance with the provisions of their agreement.<sup>164</sup> By accepting the downside risks of the project, the mortgagee purchases from the developer (in an arms-length bargain) first-priority recourse both to the project and the stream of project revenues. As between the developer and the mortgagee, the legal characterization of the occupier of the development—a nonparty to the financing contract—is properly irrelevant and forms no basis for disturbing the parties' bargained-for contractual expectations.<sup>165</sup>

Finally, the mortgagee's lien upon project cash flows is critical because a commercial real estate development is a capital asset—*for which the mortgagee provided most of the capital*—with a limited economic life. A commercial real estate project will not generate revenues forever based upon the capital borrowed from the mortgagee in order to construct, acquire, or refinance the project. As the project ages, economic and functional obsolescence diminish its revenue-generating capacity in several respects. While typical use of

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164. Only one court, *In re Mid-City Hotel Assocs.*, 114 B.R. 634 (Bankr. D. Minn. 1990), has protected the hotel mortgagee based upon the significance of the nonrecourse nature of a commercial mortgage transaction:

[T]he underlying debt was a non-recourse obligation by its terms. The parties structured the note to allow full enforcement of the debt against the real estate itself and all income generated from it, but barred any enforcement of a deficiency against [the debtor] or its general partners. This strongly suggests a bargained-for exchange of remedies, with [the mortgagee] taking the right to all income from the use of the property, in exchange for its surrender of the right to enforce the personal liability of the debtor and the responsible third parties. It is difficult to imagine that [the mortgagee] would have waived its rights to pursue collateral sources of satisfaction, had it not gained an unchallengeable right to the fruits of the use of its tangible security.

*Id.* at 642 n.9.

165. As Joshua Stein has noted, the refusal of courts to enforce the substance of the nonrecourse bargain altogether destroys the justification for the nonrecourse transaction:

Instead of accepting the negotiated remedies and walking away when the deal goes bad, the defaulting party can and often does throw the whole transaction into interminable litigation and bankruptcy proceedings, running up costs that are disproportionate to the original transaction and dragging out the process for months or years.

The limited remedies that were supposed to be available to the lender . . . become worthless. Perversely, the party in default often gains total control of the situation—either occupying the property without paying rent or debt service, or remaining a partner of the partnership with the possibility of future upside without performing its obligations . . .

Stein, *supra* note 163, at 27.

the project begins to cause substantial wear and tear,<sup>166</sup> newer projects enter the market possessing operating efficiencies and/or construction improvements that older projects do not possess.<sup>167</sup> Over time, occupiers sensitive to outward appearances tend to prefer modern projects over older ones, reducing the ability of older projects to generate competitive and increasing revenue levels.<sup>168</sup> Eventually, a project simply reaches the end of its planned economic life.<sup>169</sup> For an aged project to regain its competitive market position and generate consistent market returns, the developer must make an additional capital investment to provide the project with a new economic useful life.<sup>170</sup> By acknowledging the economic life cycle of the commercial real estate project, a court can recognize that the revenues paid by occupiers of the project during its economic useful life reflect a return upon the economic value of the project as that value is consumed over time.<sup>171</sup> Since the parties understood from the earliest stages of the transaction that the mortgagee's recourse was to that economic value, sound policy suggests that the mortgagee's recourse to project cash flows should be respected (absent compelling bankruptcy policy justifications) regardless of the legal characterization of the project's occupants.

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166. Gregory T. Bohan & Michael Cahill, *Determining the Feasibility of Hotel/Market Repositioning*, REAL EST. REV., Spring 1992, at 63, 67.

167. See, e.g., Fiedler, *supra* note 160, at 20.

168. See, e.g., *id.* (“[D]ifferences in exterior architectural design are important but not determinative factors in establishing rental differences between old and new properties.”). In discussing hotels, Bohan and Cahill refer to this phenomenon as “functional obsolescence,” or “the loss of a lodging facility’s ability to be useful and to function in accordance with current market tastes and standards.” Bohan & Cahill, *supra* note 166, at 65. As they noted, hotels “are especially vulnerable to functional obsolescence when new niche products appear within or outside their own market.” *Id.*

169. Bohan and Cahill, *supra* note 166, at 64 (“Hotel products of the 1950s and 1960s . . . are simply reaching the end of their planned economic life.”).

170. The period of time in which a project will require new capital reinvestment may in fact be quite short. For example, “[a]ll hotels require major reinvestment every five to ten years.” Peggy Berg, *Exploring Solutions in Hotel Workouts*, REAL EST. REV., Summer 1992, at 33, 38. In their article, Bohan and Cahill charted their conception of the economic life cycle of a hotel, ranging from the “young” hotel (one to five years), to the “mature” stage (three to ten years), to “middle age” (eight to seventeen years) and finally to “senior citizen” status (fifteen to thirty-five years). Bohan & Cahill, *supra* note 166, at 67.

171. See *infra* notes 220–250 and accompanying text, in which it is argued that the revenues generated by the letting of property can and should be classified as “proceeds” of the property.

**B. *Acknowledging Common Sense—Of Baseball Card Merchants and Hotel Occupancy Tax Collectors***

The notion that all income paid to occupy commercial real estate should be treated alike when pledged as security also reflects common-sense reality, as demonstrated by a personal anecdote. On a Saturday afternoon last year, my wife and I were at a local indoor mall, which was so crowded with shoppers that walking from store to store was a contact sport. The mall owners had aggravated the overcrowding by filling up the interior hallways with nearly one hundred local merchants, each hawking their wares (baseball cards, leather goods, T-shirts, art, jewelry, fudge, etc.) for the weekend only. Unlike the permanent merchants (who typically are tenants), these temporary merchants were mere licensees, not entitled to exclusive possession of their allotted space.<sup>172</sup> While I do not know what these local merchants paid the mall owner for their weekend license, I am reasonably confident that the mall owner did not donate the space. Whatever amount these temporary merchants paid, I am certain that the mall owner and its mortgagee understood that such sums constituted collateral security for the mortgage, just like any other sums paid for the use of space in the mall.<sup>173</sup>

At some point my wife—a biochemist, not a lawyer, but for some reason curious about my research—asked whether these weekend merchants paid rent just like the permanent tenants. I started to say “OF COURSE THEY DO,” but then lapsed into a classroom fantasy. Suddenly, I was no longer shopping; instead, I was attempting to explain to a classroom full of scientists the legal niceties of commercial finance as viewed in the bankruptcy courts. I explained how the mall owner borrowed the money to buy the mall from some bank, pension fund, or life insurance company. I explained how the mall owner assigned to the mortgagee, as security for its loan, all of the monies paid by mall merchants for their spaces. I tried to explain that these temporary merchants were not tenants like the permanent merchants, but were just licensees. I tried to explain that most bankruptcy courts would hold that sums paid by these temporary merchants are not “rents” because the merchants are not tenants entitled to exclusive possession of their spaces. I tried to explain that if the mall owner went bankrupt, a

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172. Of course, theoretically nothing prohibits the mall owner from using occupancy agreements for its permanent merchants that create licenses rather than landlord-tenant relationships. See *infra* note 207 and accompanying text.

173. Certainly, the sweeping language contained in most mortgage documents would include such income. See *supra* note 52 and accompanying text.



bankruptcy court might say that the mortgagee would have a security interest in the monies paid by the tenants for the use of their spaces, but not in the monies paid by the weekend merchants for their spaces. Suddenly, I was jolted from my fantasy as my wife, mystified, looked at me with a sense of disgust that I imagine scientists generally possess for lawyers.

Beneath my wife's mystification lies an obvious common-sense recognition—there is no *functional* basis for distinguishing between the money paid by the permanent mall tenant and the weekend baseball card merchant. Each is “renting” available space for a limited period of time, as the term “renting” is commonly understood, and each pays money in exchange for its limited right to use and occupy that space. When the mall owner pledges its rights to collect payment from each of those occupiers as collateral, property security law should treat the owner's rights against each occupier identically.

This common sense recognition is also reflected in the way that state legislatures have characterized hotel revenues for state sales, occupancy, and transient guest taxation purposes. Thirty-two of fifty-one jurisdictions impose such taxes either upon the “rents” or “rentals” collected by hotel owners, or upon the income or gross receipts derived from the “renting” or “leasing” of hotel rooms.<sup>174</sup>

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174. See ALA. CODE § 40-26-1 (1985) (imposing 5% excise tax upon privilege of engaging in business of renting hotel rooms); ALASKA STAT. § 29.45.650(a) (1992) (imposing sales tax upon “rents”; construed to include rental of hotel rooms in *City of Homer v. Gangl*, 650 P.2d 396 (Alaska 1982)); ARK. CODE ANN. § 26-74-501 (Michie 1992) (authorizing transient occupancy tax up to 2% of gross receipts from renting or leasing of hotel rooms); *id.* § 26-52-301(3)(B) (Michie 1992) (assessing excise tax of 3% of gross receipts from furnishing of hotel rooms to transient guests, defined as those who “rent” on less than month-to-month basis); CONN. GEN. STAT. ANN. §§ 12-407, 12-408 (West 1983 & Supp. 1993) (sales tax imposed upon renting of hotel rooms; compensation received is rent); DEL. CODE ANN. tit. 30, §§ 6101, 6102 (1985 & Supp. 1992) (occupancy tax of 8% upon rent due upon occupancy of hotel rooms); D.C. CODE ANN. §§ 47-3201, 47-3202 (1990) (consideration for occupancy of hotel room is rent); FLA. STAT. ANN. § 212.03 (West 1989) (occupancy tax of 6% of total rental receipts for occupancy of hotel rooms); HAW. REV. STAT. §§ 237D-1, 237D-2 (1992) (transient occupancy tax of 5% on gross rental received from occupancy of hotel rooms); IDAHO CODE § 50-1046 (1988) (authorizing cities to levy occupancy tax on renting of hotel rooms); ILL. ANN. STAT. ch. 120, para. 481b.32, 481b.33 (Smith-Hurd 1991) (occupancy tax imposed upon business of renting hotel rooms; tax equal to 5% of 94% of gross rental receipts); *id.* ch. 24, para. 8-3-14 (Smith-Hurd 1992) (authorizing municipalities to levy taxes upon business of renting hotel rooms); IND. CODE ANN. § 6-19-18-3 (Burns 1991) (general innkeeper's tax upon persons engaged in business of renting rooms); IOWA CODE ANN. § 422A.1 (West 1990) (authorizing occupancy tax up to 7% of gross receipts from renting of hotel rooms); *id.* § 422.43(7) (sales tax of 4% upon gross receipts from renting of hotel rooms); KAN. STAT. ANN. § 79-3603 (1989) (sales tax of 4.25% of gross receipts from renting of hotel rooms); *id.* §§ 12-1692, 12-1693

Furthermore, numerous courts faced with constitutional attacks on these taxation statutes have identified hotel room revenues as "rents" or as income derived from the "rental" of rooms.<sup>175</sup>

(1991) (authorizing transient guest tax up to 2% of gross rental receipts collected from hotel rooms); KY. REV. STAT. ANN. § 91A.390 (Michie/Bobbs-Merrill 1982) (occupancy tax equal to 3% of rent charged on hotel rooms); LA. REV. STAT. ANN. § 2740.18 (West Supp. 1993) (occupancy tax of 1% of rent of hotel rooms); *id.* § 2711.7 (1988) (same); *id.* § 2711.9 (1988) (occupancy tax of 2% of rent of hotel rooms in Iberia parish); *id.* § 2711.3 (1988) (occupancy tax of 1/2% of rent of hotel rooms in city of New Orleans); ME. REV. STAT. ANN. tit. 36, § 1811 (West 1990) (sales tax assessed upon value of rental of hotel room); MD. CODE ANN. art. 24, §§ 9-301 to 9-304 (Supp. 1991) (occupancy tax charged upon rental of hotel rooms); MASS. ANN. LAWS ch. 64G §§ 1, 3, 3A (Law. Co-op. 1988) (compensation from occupancy of hotel rooms is rent); MO. ANN. STAT. § 67.671 (Vernon 1989) (tourism sales tax charged upon rental charges paid by transient hotel guests); NEB. REV. STAT. §§ 77-2702(13)(f), 77-2703 (1990) (sales tax imposed upon rental of hotel rooms); NEV. REV. STAT. § 244.3352 (1991) (authorizing counties to impose occupancy tax upon gross receipts from rental of transient lodging); *id.* § 268.096 (1991) (authorizing cities to impose occupancy tax upon gross receipts from rents of transient lodging); N.H. REV. STAT. ANN. §§ 78-A:1, 78-A:3, 78-A:6 (1991) (compensation from occupancy of hotel rooms is rent); N.J. STAT. ANN. § 54:32B-3(d) (West 1986) (sales tax imposed upon rent received from occupancy of hotel rooms); N.M. STAT. ANN. §§ 3-38-13 to 3-38-15 (Michie 1984 & Supp. 1991) (compensation received from occupancy of hotel rooms is rent); N.Y. UNCONSOL. LAW § 9441 (McKinney Supp. 1993) (authorizing occupancy tax upon rent collected for occupancy of hotel rooms); N.Y. TAX LAW §§ 1202-a to 1202-k (McKinney 1987 & Supp. 1993) (authorizing assessment of occupancy tax upon rental of hotel rooms in Onandaga, Broome, Jefferson, Oneida, Schenectady, Tompkins, Cortland, Saratoga, Steuben, Westchester, Chemung, Oswego, Schuyler, Ostego, Sullivan, Tioga, Chautauqua, Montgomery, and Rockland Counties); N.C. GEN. STAT. § 105-164.4 (1992) (sales tax assessed upon rents collected from rental of hotel rooms); N.D. CENT. CODE §§ 40-57.3-01, 40-57.3-01.1 (Supp. 1992) (city lodging tax assessed upon rental or leasing of hotel rooms); *id.* § 57-39.2-02.1 (Supp. 1991) (5% sales tax assessed upon rental or leasing of hotel rooms); PA. STAT. ANN. tit. 72, §§ 7209, 7210 (1990) (6% excise tax upon rent received for occupancy of hotel rooms); S.C. CODE ANN. § 12-36-920 (Law. Co-op. Supp. 1992) (7% sales tax assessed upon rental of hotel rooms); S.D. CODIFIED LAWS ANN. § 10-45-7 (1989) (sales tax assessed upon rental of hotel rooms); UTAH CODE ANN. § 59-12-301 (1992) (3% transient room tax upon rent received for occupancy of hotel rooms); VT. STAT. ANN. tit. 32, §§ 9202, 9241 (1991) (meals and room tax assessed upon rent received for occupancy of hotel rooms); *see also* CAL. REV. & TAX. CODE § 7281 (West 1987) (authorizing transient occupancy tax upon the renting of mobile homes for occupancy by transient guests).

175. *See, e.g.,* United States v. Montgomery County, Md., 761 F.2d 998 (4th Cir. 1985); City of Homer v. Gangl, 650 P.2d 396 (Alaska 1982); People v. Evans, 57 Cal. Rptr. 276 (Ct. App. 1967); Gowens v. City of Bakersfield, 13 Cal. Rptr. 820 (Dist. Ct. App. 1961); Alachua County v. Dep't of Revenue, 466 So. 2d 1186 (Fla. Dist. Ct. App. 1985); Greater Boise Auditorium Dist. v. Royal Inn, 684 P.2d 286 (Idaho 1984); Marcus Corp. v. Village of S. Holland, 458 N.E.2d 112 (Ill. App. Ct. 1983); Springfield Hotel-Motel Ass'n v. City of Springfield, 457 N.E.2d 1017 (Ill. App. Ct. 1983); City of Lexington v. Motel Developers, Inc., 465 S.W.2d 253 (Ky. 1971); Second Street Properties, Inc. v. Fiscal Court, 445 S.W.2d 709 (Ky. 1969); William Reilly Constr. Corp. v. City of New York, 334 N.Y.S.2d 459 (Sup. Ct. 1964); Allegheny County v. Monzo, 500 A.2d 1096 (Pa. 1985); Ambassador Athletic Club v. Utah State Tax Comm'n, 496 P.2d

### C. *Applying Common Sense in the Bankruptcy Context*

Fortunately, a precious few courts have demonstrated the instinct to reject legal form in favor of economic substance in evaluating the commercial real estate mortgage transaction. One example is the United States Bankruptcy Court for the District of Minnesota in its decision in *In re Mid-City Hotel Associates*.<sup>176</sup> As discussed in Part I, the debtor in *Mid-City Hotel* sought to avoid its mortgagee's asserted lien upon postpetition room revenues on the ground that hotel revenues were not "rents," "issues," or "profits" of the hotel. While the *Mid-City Hotel* court regrettably concluded that hotel room revenues are not "rents" (because hotel guests are not "tenants"),<sup>177</sup> the court nonetheless held that postpetition room revenues are "profits" of the land and thus subject to the mortgagee's security interest.<sup>178</sup> In reaching this decision, the court relied heavily upon the economic realities underlying commercial mortgage financing:

Common sense, and a reasonable divination of the parties' own intentions, also support this conclusion. . . .

[The mortgage and the assignment of rents, issues and profits] were integrally related, and were executed in conjunction with one another. This circumstance, and the instruments themselves, clearly evidence the parties' intent to subject all of the economic fruits of [the debtor's] direct physical use of the real-property interests to a lien in favor of [the mortgagee], to secure payment of the debt. That physical use, of course, is the provision of rooms to guests.<sup>179</sup>

The *Mid-City Hotel* court rejected the analysis of the contrary hotel bankruptcy decisions for failing "to consider the parties' actual intent . . . as to the scope of the creditors' security" and failing "to recognize the economic realities" of hotel mortgage financing. Motivated by these realities, the *Mid-City Hotel* court recognized that the hotel was worth only the discounted sum of its operating revenues, which the owner intended to and did pledge as security

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883 (Utah 1972); *Howe v. Tax Comm'n*, 353 P.2d 468 (Utah 1960); *Bedford v. Vermont Dep't of Taxes*, 505 A.2d 658 (Vt. 1985).

176. 114 B.R. 634 (Bankr. D. Minn. 1990).

177. *Id.* at 640-41; see also *supra* notes 27-31 and accompanying text.

178. The court defined "profit" as "[t]he benefit, advantage, or pecuniary gain accruing to the owner or occupant of land from its actual use; as in the familiar phrase, 'rents, issues and profits' . . ." 114 B.R. at 641 (quoting BLACK'S LAW DICTIONARY 1090 (5th ed. 1979)).

179. *Id.* at 641-42 (footnotes omitted).

for the nonrecourse mortgage debt.<sup>180</sup> As the court noted, “[i]t is difficult to imagine that [the mortgagee] would have waived its rights to pursue collateral sources of satisfaction, had it not gained an unchallengeable right to the fruits of the use of its tangible security.”<sup>181</sup> By construing the mortgage documents in a manner consistent with the underlying structure of the transaction, the *Mid-City Hotel* court reached a result perfectly consistent with both the law of real property and the contractual expectations of the parties.

The soundness of the position taken by the *Mid-City Hotel* court and several other courts<sup>182</sup> provides a clear foundation for the proposed *Restatement* to treat all sums paid by licensee occupiers of land as “rent.”<sup>183</sup> Unfortunately, most bankruptcy courts administering distressed hotels remain bound to formalism and the weight of authority, disregarding the structure of the hotel financing transaction and refusing to give effect to the developer/mortgagee bargain. Because there is no apparent bankruptcy policy that requires the disapproval or nonenforcement of this bargain, the bankruptcy courts’ formalistic use of section 552 to extinguish the hotel mortgagee’s lien upon postpetition revenue is especially suspect. In the Bankruptcy Code, Congress struck a careful balance between debt-

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180. One court has gone even further and suggested that the structure of hotel financing requires a conclusion that room revenues are rent:

Hotel room revenues are, or resemble, rents in that they are a primary component used by appraisers in valuing a hotel. The value of the income stream, rents, is a major factor in determining the value of the real property. The income is what the debtor and the secured lender look to for payment of the loan. To subtract room revenue from the consensual real property security greatly reduces the value of the creditor’s collateral package.

*In re S.F. Drake Hotel Assocs.*, 131 B.R. 156, 160 (Bankr. N.D. Cal. 1991), *aff’d*, 147 B.R. 538 (N.D. Cal. 1992); *see also* Berg, *supra* note 170, at 35 (“Today . . . hotels are trading as businesses and are valued on the basis of their revenue streams.”).

181. *Mid-City Hotel*, 114 B.R. at 642 n.9.

182. *See, e.g., In re Everett Home Town Ltd. Partnership*, 146 B.R. 453, 458 (Bankr. D. Ariz. 1992) (revenues generated by resort suites treated as “rents”); *In re Miami Ctr. Assocs.*, 144 B.R. 937, 941 (Bankr. S.D. Fla. 1992) (hotel room revenues are “profits” of hotel subject to lender’s prepetition lien); *In re S.F. Drake Hotel Assocs.*, 131 B.R. at 160 (hotel room revenues are rent), *aff’d*, 147 B.R. 538, 539 (N.D. Cal. 1992); *In re Ashford Apartments Ltd. Partnership*, 132 B.R. 217, 218 (Bankr. D. Mass. 1991) (revenues generated by parking garage are rent); *In re Flower City Nursing Home, Inc.*, 38 B.R. 642, 644–45 (Bankr. W.D.N.Y. 1984) (funds attributable to use and occupation of nursing home were “attributable to real property” and thus constituted “rents and profits”); *Great-West Life Assurance Co. v. Raintree Inn*, 837 P.2d 267, 270-71 (Colo. App. 1992) (recorded deed of trust granting security interest in all “rents, issues and profits, income and revenue” created valid security interest in hotel room revenues).

183. RESTATEMENT (THIRD), *supra* note 13, § 4.2(a).

ors desiring to use operating revenues and secured parties claiming a lien upon such revenues. If hotel operating revenues constitute the mortgagee's cash collateral, the bankruptcy court can permit the debtor to use them in order to pay operating and maintenance expenses; payment of those expenses provides adequate protection of the mortgagee's secured interest.<sup>184</sup> Furthermore, the debtor may use postpetition room revenues, even beyond the extent necessary for operating and maintenance expenses, if the debtor can provide adequate protection of the mortgagee's interest in those revenues.<sup>185</sup> Finally, section 552(b) authorizes the bankruptcy court to permit the debtor to use postpetition revenues *free of the creditor's lien altogether* if the "equities of the case" suggest that such unlimited use is warranted.<sup>186</sup>

Congress thus has provided statutory mechanisms for bankruptcy courts to provide the bankrupt developer with use of postpetition room revenues. These mechanisms may be narrow ones, but they are necessarily narrow; they reflect the congressional mandate that courts must respect the mortgagee's bargained-for rights to security. By resorting to conceptual formalism to provide the debtor with broader access to postpetition revenues, bankruptcy courts are circumventing the debtor-secured party balance struck by Congress in section 363. Courts instead should respect the mortgagee's lien upon postpetition revenues, and permit the debtor to use them only if the debtor can provide the mortgagee with adequate protection or if the "equities of the case" so warrant.

#### IV. TOWARD A COHERENT FRAMEWORK FOR SECURING INCOME FROM THE COMMERCIAL REAL ESTATE DEVELOPMENT

Lurking beneath the surface of the hotel bankruptcy cases are larger conceptual questions that have bedeviled the analysis of bankruptcy courts in administering distressed income-producing

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184. See 11 U.S.C. § 363(c)(2) (1988) (debtor-in-possession may use cash collateral if authorized by court after notice and hearing); *id.* § 363(e) (court can condition debtor-in-possession's use of cash collateral as is necessary to provide adequate protection of secured creditor's interest therein). Since the mortgagee would have to use operating revenues to pay operating expenses if the mortgagee were in possession of the property, the court certainly should permit the debtor-in-possession to use the same revenues to pay those expenses.

185. *Id.* § 363(e).

186. *Id.* § 552(b). As the final floor statements accompanying § 552(b) note: "[Section 552(b)] allows the court to consider the equities in each case. In the course of such consideration the court may evaluate any expenditures by the estate relating to proceeds and any related improvement in position of the secured party." 124 CONG. REC. 32,400 (1978).

real estate. What *is* the true nature of the revenue generated by a commercial land development? Is it realty or personalty? Should security law characterize revenue paid for the occupation of land as fundamentally in the nature of land, with assignments perfected according to land security law? Or instead, should security law treat all such revenue as personalty, with assignments perfected according to the UCC?

Instead of examining these questions in depth, courts have relied upon orthodox historical conceptions. Courts have tended to question whether a particular type of revenue falls within the scope of "rent," and if so, they have classified that income as realty, subject to real estate security law. And when pushed in difficult cases to determine whether a particular type of revenue is "rent," courts often have relied upon another traditional distinction drawn by land security law—whether the revenue was generated primarily by "the use or occupancy of real estate" or "from the sale of goods and services."<sup>187</sup> In hotel cases, for example, this distinction has led courts to suggest that because room revenues derive from the owner's provision of services, not from its bare ownership of land, room revenues cannot constitute "rent" in the nature of realty.<sup>188</sup>

This distinction, referred to here as the "land/services distinction," has an extensive common law pedigree, but does it have any continuing utility as a basis for determining the character of the revenue generated by the modern commercial real estate development? The remainder of this Article shifts its focus in an attempt to provide a new conceptual paradigm for security law to use in characterizing sums paid by occupiers of land. While Parts I through III asked "Are hotel room revenues 'rent'?", Part IV instead asks "What is the nature of the sums paid by occupiers of land, and is there a concept other than 'rent' that is more helpful in characterizing those sums?"

Part IV first reviews the traditional land/services distinction and demonstrates that it has diminished meaning and validity when applied to the occupier of the modern commercial real estate development.<sup>189</sup> The modern commercial land development involves an inextricable blend of land and services, each constituting an essential part of the bargain between developer and occupier. If payment obligations are "rent" only when they are incurred *solely* for the use of land, then security law uses the term "rent" in an artificial man-

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187. RESTATEMENT (THIRD), *supra* note 13, § 4.2 reporter's note, at 78.

188. See *infra* note 205 and accompanying text.

189. See *infra* notes 192–219 and accompanying text.

ner to describe the sums paid by the modern occupier of commercial real estate. The distinction thus clouds rather than clarifies the proper characterization of the revenues paid by such occupiers.

Part IV then recommends alternative conceptions that are informed by the nature of commercial land development and the realities of commercial mortgage financing. Part IV suggests that revenues paid by occupiers of commercial real estate constitute "proceeds" of the underlying real estate collateral.<sup>190</sup> The developer of a modern commercial real estate project acquires a productive capital asset with a limited economic life—an inventory of space units (of a certain appointed quality) available for temporary occupation during the project's economic life. The sum of these units over the development's useful life reflects the development's productive capacity, which is the true economic value of the real estate collateral. Viewed in this light, one may designate the revenue paid in exchange for each unit as "proceeds" of the disposition of that portion of the development's economic value. As such, security law coherently may treat such revenues as "proceeds" of the underlying mortgage collateral, with liens upon such revenues protected in bankruptcy under Bankruptcy Code section 552(b).

Part IV concludes that once the land/services distinction is rejected, there remains no sensible policy basis upon which to treat "rent" as an interest in realty beyond the scope of UCC Article 9. Instead, security law should treat the assignment of a lease or occupancy contract as it treats the assignment of an installment land contract. Both the lease and the installment land contract involve the purchase of an interest in land in exchange for the payment of contractual installments. In analyzing assignments of installment land contracts, courts have characterized the vendor's rights to the vendee's contract installments as personal property collateral. Since the mortgagee's goal in obtaining an assignment of rents is access to the lessee's contract installments, security law likewise should characterize the right to collect those installments as personal property collateral. By bringing assignments of leases and rents within the scope of the UCC, those charged with revising Article 9 can provide much-needed coherence and transactional certainty to the financing of commercial real estate development transactions.<sup>191</sup>

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190. See *infra* notes 220–250 and accompanying text.

191. See *infra* notes 251–267 and accompanying text.

A. *The Land/Services Distinction as Applied to Income from Real Estate*

The land/services distinction is rooted in the common law's conception of rent as an incorporeal hereditament that issued directly out of the land.<sup>192</sup> Under this conception, there is a conclusive presumption that the land itself generates the rent, which is a return purely upon the ownership of the land. Influenced by this conception, early scholars argued that sums designated as "rent" by the parties but properly attributable to the landowner's business efforts were not properly "rent" in the nature of land.<sup>193</sup> If one carries this analysis to its extreme, the term "rent" necessarily would exclude any sum received by the owner for providing business services to the occupier.<sup>194</sup>

One of the first modern cases to discuss and apply the land/services distinction in detail is the decision of the United States District Court for the Southern District of New York in *Grusmark v. Echelman*.<sup>195</sup> In *Grusmark*, the mortgagee of a summer resort had requested and obtained the appointment of a receiver pending foreclosure of the mortgage. The receiver had taken possession of the resort, which rented vacation bungalows to families and also provided a child day camp, child-care services, and entertainment ac-

192. See DIGBY, *supra* note 56, at 231; 1 TIFFANY, *supra* note 56, § 165, at 1009. This conception contrasts with the civil law's conception of rent as a "civil profit" that does not issue from the land itself, but acquires its status as a profit solely by operation of law. See *supra* notes 105-107 and accompanying text.

193. See, e.g., 1 TIFFANY, *supra* note 56, § 169, at 1022-23 (sums reserved as compensation for good will, for making of improvements by landlord, or to reimburse landlord for repairs, are not "rent" even if so termed by parties to lease).

194. The land/services distinction may reflect the influence of early economists and their conceptions of economic rent. David Ricardo defined rent as "that portion of the produce of the earth which is paid to the landlord for the use of the original and indestructible powers of the soil." FRANCIS A. WALKER, *LAND AND ITS RENT* 35 (1883). This notion of economic land-rent did not include any return attributable to effort expended upon the land by the landowner:

Ricardo limited his definition of rent to the income from land. That part of a contract payment made by a tenant to a landlord which represented improvement in the quality of the land or an investment in leased buildings, fences, and other equipment was not classified as rent. In general, this view . . . has been further clarified by excluding from rent, profit and all earnings of labor, whether that of hired employees or the cultivator himself.

CARL R. BYE, *DEVELOPMENTS AND ISSUES IN THE THEORY OF RENT* 2 (1940) (footnote omitted). Instead, Ricardo perceived of "rent" as a pure "gift of nature," not including payment "for any *personal* productive services rendered by the landowners." OVERTON H. TAYLOR, *A HISTORY OF ECONOMIC THOUGHT* 370 (1960).

195. 162 F. Supp. 49 (S.D.N.Y. 1958).



tivities for its adult guests.<sup>196</sup> The owner sought to have the receivership order vacated, arguing that (a) no receiver can "be appointed unless there are actual rents and profits" and (b) the operation of a summer resort did not generate "rents and profits."<sup>197</sup> The *Grusmark* court agreed with the owner and vacated the receivership order.<sup>198</sup> In doing so, the court addressed the scope of the term "rents and profits":

Clearly, if the mortgagor is in total possession of the premises as in the case of a dwelling house, there are no rents and profits and therefore there is no occasion for the appointment of a receiver to collect them. The same is true if he is in possession of mortgaged premises on which he is conducting a business. On the other hand, an apartment house that is occupied by tenants produces rents in the form of payments by the tenants which are compensation primarily for the use of the property although they may cover also incidental services such as heat, gas and electricity. The concept of rent has been expanded to cover the income from some businesses operated on real property . . . [such as] the operation of a garage by a receiver of rents and profits where the main business of the garage was leasing space to automobile owners. On the other hand, a receiver of rents and profits was not permitted to take possession of and operate a restaurant and dance hall on the ground that there were no rents and profits . . . .<sup>199</sup>

The court decided that the receiver's right to possession of the resort depended upon the resort's primary function, which the court found was "to entertain the customers and care for their children as well as to lease them furnished bungalows."<sup>200</sup> In characterizing the resort's revenues, however, the court concluded that because of "[t]he extensive scope of the services rendered" by the owner, "a large part of the income from the business is not earned by the real estate and is therefore not rent."<sup>201</sup> As a result, the court held that the receiver was not entitled to possession of the business, and ordered the receiver to return possession to the owner pending foreclosure.<sup>202</sup> Nevertheless, the court went on to hold that "undoubtedly a substantial portion of the income earned was rent

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196. *Id.* at 50. It is not clear from the language of the court's opinion whether the resort's guests were tenants or licensees.

197. *Id.* at 51.

198. *Id.* at 52.

199. *Id.* at 51 (citations and footnote omitted). The examples used in the quoted passage are discussed in some detail by Professors Nelson and Whitman in their treatise on real estate finance. See GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 4.41, at 248-49 (2d ed. 1985).

200. 162 F. Supp. at 51.

201. *Id.* at 51-52.

202. *Id.* at 52-53.

paid for the use of the real estate."<sup>203</sup> Since receivers are legally entitled to collect rents, the court ordered the owner to pay the receiver the reasonable rental value of the premises in accordance with the terms of the mortgage.<sup>204</sup>

None of the hotel bankruptcy cases have relied upon *Grusmark* as authority. A number of courts have adopted the land/services distinction embraced in *Grusmark*, but have applied it in a questionable manner. These courts have concluded that a hotel is a business operation, with guests paying revenues primarily in exchange for the owner's personal services, such that room revenues cannot be characterized as rent.<sup>205</sup> This conclusion provides no basis, however, to distinguish a hotel project from an apartment project or any other commercial land development. These courts implicitly assume that a hotel is a business operation and is thus different from an apartment complex—which, presumably, must somehow *not* be a business operation. Merely stating this assumption illustrates how preposterous it is. Each is a business in which the developer provides available space of a certain type and quality for temporary occupation. To the developer, making space available and providing services to the occupiers are not mutually exclusive activities.<sup>206</sup>

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203. *Id.* at 52.

204. *Id.*

205. See, e.g., *In re The Green Corp.*, No. 92-10903, 1993 WL 180921, at \*5-6 (Bankr. D. Me. May 18, 1993); *In re Thunderbird Inn, Inc.*, 151 B.R. 224, 226-27 (Bankr. D. Ariz. 1993); *Financial Sec. Assurance, Inc. v. Days Cal. Riverside Ltd. Partnership*, No. S-92-119GEB, 1992 WL 471706, at \*3 (E.D. Cal. Aug. 18, 1992); *United States v. PS Hotel Corp.*, 404 F. Supp. 1188, 1192 (E.D. Mo. 1975); cf. *In re Hillside Assocs. Ltd. Partnership*, 121 B.R. 23, 24 (Bankr. 9th Cir. 1990) (nursing home charges are for services and are not rents); *In re GGVXX, Ltd.*, 130 B.R. 322, 325-26 (Bankr. D. Colo. 1991) (golf course fees paid in exchange for services are not rents); *In re Woodstock Assocs. I, Inc.*, 120 B.R. 436, 444 (Bankr. N.D. Ill. 1990) (nursing home charges are for services and are not rents).

206. At its core, commercial real estate is essentially a service activity. As one commentator has noted:

Individual real estate executives are really functional experts in specific areas like sales, finance, construction, or design. The medium through which they exercise their talents is called real estate.

In the vertical chain of business activity, the functions most real estate firms perform are (1) assisting tenants to distribute goods and services (shopping centers and warehouses); (2) assisting tenants to create, market, or stimulate ideas, and to process information about their products (office buildings); or (3) providing tenants with what the architect Le Corbusier called machines for living (houses, hotels, and apartments).

Paul Z. Pilzer, *The Real Estate Business and Technological Obsolescence*, *REAL EST. REV.*, Fall 1989, at 30, 31. Pilzer suggests that commercial real estate development has always been a service activity, but that recognition of this fact was obscured "as long as

In the modern commercial real estate development, the sums paid by an occupier are compensation both for the occupier's bare right to occupy the space and for the provision of business services promised by the owner. One cannot accurately allocate the entire payment solely to the use of the land or solely to the services provided—both are a necessary component of the exchange. This conclusion can be shown by a comparison of three hypothetical projects—the Shady Acres Apartments, the Shady Rest Hotel, and the local Spiffy Lube. Each generates income in the form of cash payments made by occupiers in exchange for two “benefits.” One benefit is the right to occupy the exploited land without trespassing. At Spiffy Lube, this right is merely a license lasting approximately twenty-five minutes; at Shady Acres Apartments, it is likely a non-freehold estate lasting a year or more.<sup>207</sup> In each case, however, the customer receives some right to occupy the land, and some portion of each customer's payment is properly allocable to the developer's ownership of the land.<sup>208</sup>

Each customer also receives a second benefit—the personal services and business efforts promised by the owner or its agents. These services relate integrally to the customer's occupation of the

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our rapidly developing country continued to have a general shortage of developed real property.” *Id.*

207. Of course, the owner of Shady Acres could draft its documentation such that occupiers were in fact licensees rather than tenants. *See, e.g.,* *Wenner v. Dayton-Hudson Corp.*, 598 P.2d 1022, 1023–27 (Ariz. Ct. App. 1979) (income received by department store owner under agreements that permitted “licensee” to operate department within store was not income derived from leasing or renting land, since licensee had no right to exclusive possession of any part of store building); *Cook v. University Plaza*, 427 N.E.2d 405, 406–08 (Ill. App. Ct. 1981) (residents of privately-owned student dorm not “tenants” but “licensees,” since residence hall contracts allowed owner to relocate occupiers at will).

208. In the Shady Acres Apartments case, one easily can see why some portion of each occupier's payment is allocable to the land. In the Spiffy Lube case, the allocation is not so clear, but several factors require that one allocate some portion of the customer's fee to the developer's mere ownership of land. First, from a pure cost allocation perspective, some portion of that fee reflects an internalization of the cost of the underlying real estate. This explains why the customer of an urban Spiffy Lube (which is built upon costlier real estate) may have to pay \$30.95 for the same service for which the customer of a rural Spiffy Lube pays \$24.95; each owner simply internalizes the differential costs of the underlying real estate. Second, from a customer preference perspective, a Spiffy Lube customer may choose to use a particular Spiffy Lube because the land upon which it is located is more convenient than the land owned by some alternative service provider. This convenience is a key factor; one would not see a Spiffy Lube constructed on inexpensive land far removed from any population center. Since the customer's decision to use a particular Spiffy Lube may reflect some locational preference, some portion of that customer's payment should be allocated to the underlying land. *See infra* text accompanying note 212.

land; usually they occur directly on the land. At Spiffy Lube, these services include the labor, oil, and lube used to service the customer's car, and the coffee she drinks and the magazines she reads while she waits. At Shady Acres, these services include tenant recreational facilities, resident managers, tenant social activities, common area maintenance, rubbish disposal, security, and any other perquisites promised by the owner. Economically, some portion of each customer's payment is allocable not to the mere use of the land, but to the provision of these collateral services.

The proper allocation of each customer's payment to land and services varies from development to development, depending upon the underlying facts. Much of the tenant's monthly rent payment at Shady Acres is allocable to her occupation of her space, yet some portion is allocable to the owner's personal services. In contrast, most of the \$24.95 paid to Spiffy Lube to service a car is properly allocable to the owner's mechanical services, yet some portion of that payment (however small) is properly allocable to the temporary occupation of the underlying land. The Shady Rest Hotel falls somewhere between these extremes. A significant portion of the guest's bill is attributable to the guest's bare right to occupy the room. Another significant portion of the bill is allocable to the provision of guest services attendant to a hotel stay—the front desk clerk who takes messages, maid service, fresh towels, the mint on the pillow, the pool, etc.<sup>209</sup>

If security law truly took the land/services distinction seriously, a proper characterization of the revenues from these hypothetical projects would require a sliding-scale allocation of income *both* to land *and* to services, with the allocation weighted more

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209. The argument that hotel revenues reflect a payment solely for services rather than use is fantasy. First, in terms of customer preferences for land versus services, I have yet to meet a person who chooses to stay in a hotel *only* because someone makes the bed and leaves a mint on the pillow. Persons stay in hotels to avoid sleeping in cars, in airports, on sidewalks, or in other equally uncomfortable and unsafe places when away from home. Second, from a cost perspective, some portion of the room rate must be allocable to the underlying land. This is evident from Tom Bodette's radio commercial observation that a room at Motel 6 costs "around 28 bucks, a little more in some places, a little less in others." All Motel 6 outlets provide essentially the same services; the price differential reflects that owners of more expensive outlets are internalizing the costs of their particular locations.

The *only* way one can argue persuasively that room rates are attributable solely to "services" is to define "services" to include the provision of desirable space for temporary occupation. That is a plausible definition of "services." If one defines "services" that broadly, however, then all rents paid by tenants of any commercial real estate development are also wholly allocable to "services," and there is no basis for distinguishing the hotel from other income-producing real estate projects.

heavily in favor of services as their relative predominance within the owner/occupier bargain increases. And if security law applied the land/services distinction consistently, it would make the appropriate allocations for every commercial development, regardless of the legal status of the occupiers. That portion of a tenant's contractual rental payment allocable to the mere occupation of the land would be treated as "rent" in the nature of realty; that amount allocable to services would not be "rent" (and thus would be treated as personally). This is precisely what the court attempted in *Grusmark v. Echelman*, modifying the receivership order to allow the resort owner to retain the business and the "nonrent" portion of the revenues, while permitting the receiver to collect the portion of the revenues that was "rent" allocable to the land.<sup>210</sup>

Upon reflection, one begins to appreciate the practical obstacles to making these allocations. The first obstacle concerns the tracking of historical cost data. Even if one assumes that all occupiers equally value the importance of services to their bargains, requiring a land/services allocation would require parties to compile and analyze historical information concerning the developer's capital and operational costs in order to allocate revenue properly into its rent/nonrent components. Complying with this requirement would involve time and expense,<sup>211</sup> with nothing gained save the integrity of the common law's conception of rent as issuing directly from the land. The second and larger obstacle is that all occupiers of a project are not alike. The extent to which different occupiers are concerned about "mere occupation of space" as opposed to "personal services" is a function of each occupier's respective preferences. As an empirical matter, these preferences may be impossible to measure accurately (and may change over time), thus rendering the correctness of any particular allocation open to question.<sup>212</sup>

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210. *Grusmark v. Echelman*, 162 F. Supp. 48, 52 (S.D.N.Y. 1958).

211. *Cf. BYE*, *supra* note 194, at 29 ("The extent to which any land income is earned [thus being in the nature of economic land-rent] or unearned [not in the nature of economic land-rent], cost or surplus, can be accurately determined only by an historical cost valuation in each particular instance." (quoting H.B. DORAU & ALBERT HINMAN, *URBAN LAND ECONOMICS* 493 (1928))). Furthermore, requiring such allocations could present some documentation problems, as parties to a transaction attempt to project what amount of future income will be "rent" and what amount will not (with the "land security law vs. UCC" consequences that follow from that characterization).

212. The drafters of the proposed *Restatement* have recognized that "[a]ttempts to segregate [income allocable to land versus services] can be little more than arbitrary estimates in most cases." *RESTATEMENT (THIRD)*, *supra* note 13, § 4.2 reporter's note, at 79.

Most significantly, requiring an allocation would be artificial given the contractual behavior of owners and occupiers of commercial real estate. In making an occupancy agreement such as a lease, the owner and the occupier typically do not separate the occupier's payment obligation into a "use" component and a "services" component; rather, the occupier agrees to make one payment in exchange for all benefits received.<sup>213</sup> In this respect, an apartment unit, a suite of offices, a small-tenant space in a shopping mall, and a hotel room do not differ substantively from each other. The developer is not offering mere space for a price, but a particular type and quality of space for that price. For example, the mom-and-pop tenant in a local strip mall may pay \$2000 rent each month for possession of its space, but for that payment the tenant expects more than just the bare legal right to occupy that space. The tenant also expects to receive the delivery of services that constitute an integral part of the "product" it buys: regular common area maintenance; the presence of an anchor tenant possessing strong retailing expertise and customer loyalty; a competent property manager with integrity and marketing skill; promotional and advertising support; the developer's promises not to make space available to certain types of tenants or potential competitors, etc. These services are an integral part of the developer's product; take one or more away, and the value of that product (reflected in the \$2000 market rent) will decline rapidly compared to competing projects.<sup>214</sup> This analysis also applies to a hotel project. The business traveller who pays \$200 per night to stay at the Ritz-Carlton expects not only the right to occupy that room but also the delivery of the services that make up the Ritz-Carlton's "product"—the prompt and courteous delivery of all services promised by the owner and included within that \$200 rate. In this sense, "rent" (or whatever term one uses to describe

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213. See, e.g., Humbach, *supra* note 90, at 1261 ("The typical lease of space in a multi-unit building is not merely an exchange of rent for possession. Rather, it is an exchange of rent for possession-plus-services.").

Many commercial leases do require the tenant to make a separate payment for common area maintenance ("CAM"). Most such leases, however, specifically describe the tenant's CAM obligations as "rent," and courts have tended to treat CAM payments as part of the tenant's regular contractual rent payment. See, e.g., *In re Mount Pleasant Ltd. Partnership*, 144 B.R. 727, 731 n.2 (Bankr. W.D. Mich. 1992) (noting that rents at issue in case may have included CAM charges); *In re Graham Square, Inc.*, 122 B.R. 527, 529-30 (Bankr. N.D. Ohio 1990) (rent and CAM payments not distinguished in order regarding use of cash collateral); *In re Fernandes Supermarkets, Inc.*, 1 B.R. 249, 251 (Bankr. D. Mass. 1979) (tenant's "gross rent" included CAM charges).

214. The developer can receive a higher rent for space in a new, fully-leased, convenient, Wal-Mart-anchored shopping center than for the same amount of space in an older shopping center without an anchor tenant.

the payment made by an occupier of land) is not "simply a quid pro quo for possession"<sup>215</sup> of land separable from the developer's services; the two are inextricably intertwined.<sup>216</sup>

These practical obstacles may explain why most courts have rejected the land/services distinction altogether in the landlord-tenant context. In evaluating commercial developments in which owners and occupiers stand in a landlord-tenant relationship, courts have refused to require an allocation of revenue between land and services. Instead, property law and property security law have chosen to allocate 100% of the tenant's contractual obligation to the land, treating the entire payment as rent in the nature of land. Security law thus uses the term "rent" in an artificial manner, treating as land sums that are allocable as an economic matter to something other than land.<sup>217</sup>

Unfortunately, rather than acknowledging that security law uses the term "rent" artificially, courts have grounded this 100% allocation to land upon the unrealistic historical assumption of landlord-tenant law that a tenant pays rent only for the use of the land itself, with services forming a collateral aspect of the exchange.<sup>218</sup> The tenant is "deemed" to intend to allocate all of its contractual obligation to the use of the land, regardless of the ten-

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215. Thomas M. Quinn & Earl Phillips, *The Law of Landlord-Tenant: A Critical Evaluation of the Past with Guidelines for the Future*, 38 *FORDHAM L. REV.* 225, 250-51 (1969).

216. As one judge has noted, rents "do not spring from the ground. Real estate must be maintained and serviced to produce them, much as a contract must be performed to bring payment under it." *In re Prichard Plaza Assocs. Ltd. Partnership*, 84 B.R. 289, 298 (Bankr. D. Mass. 1988).

217. A useful analogy may be drawn here to the contract for the sale of goods (which is governed by UCC Article 2) and the contract for the sale of services (which is not governed by Article 2). The UCC makes no provision for dealing with the hybrid contract that contains both "goods" and "services" components. Accordingly, rather than allocate the contract between goods and services, courts generally have forced the hybrid contract into either the "goods" or "services" paradigm, depending upon the "predominance" of services to the bargain. See 1 RONALD A. ANDERSON, *ANDERSON ON THE UNIFORM COMMERCIAL CODE* §§ 2-105:36 to 38, at 579-84 (3d ed. 1981 & Supp. 1992) (collecting cases). As the buyer is contracting for a product that is composed of both goods and services, the courts' all-or-nothing allocation to either goods or services is artificial. In contrast, a minority of courts have treated such hybrid contracts as effectively divisible into two contracts—one for the sale of goods (subject to Article 2) and one for the sale of services (not subject to Article 2). See, e.g., *Anthony Pools v. Sheehan*, 455 A.2d 434, 437-41 (Md. 1983).

218. Scholars have criticized this assumption as unwarranted and unfair in the context of the residential landlord-tenant relationship. For example, Professors Thomas Quinn and Earl Phillips argued that the common law's treatment of rent as the quid pro quo for possession bifurcated the landlord-tenant contract into two levels, a possession level and a services level:

ant's actual preferences regarding the importance of services to her bargain. In turn, the hotel bankruptcy cases have turned this assumption on its head, conclusively presuming that the services provided to a hotel guest are so predominant to the guest's bargain that they cannot constitute a collateral part of the bargain. As a result, the courts choose to allocate the guest's entire payment to services, and none of the payment is treated as "rent" in the nature of realty. The guest is "deemed" to intend to allocate 100% of his contractual obligation to the receipt of services, regardless of his actual preferences.

This distinction between the tenant and the hotel guest is perverse. The expectations of each are essentially the same; each expects both undisturbed occupancy and the delivery of the developer's promised services that give that right of occupancy its value.<sup>219</sup> Property security law certainly may choose to refuse to allocate an occupier's payment into its "land" and "services" components, but the reason for that refusal should have some connection with reality and should be consistently applied to similar transactions. It may be legitimate for security law to refuse to allocate the occupier's payment obligation between land and services because it is too difficult to make those allocations or to measure each occupier's preferences. That approach demonstrates reasoning informed by reality. In contrast, it is pure fiction for security law to

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Significantly, the two levels were separate and distinct. A failure to perform on one level generated a remedy on that level, but in no way affected the other level. In technical terms, the covenants on one level were not reciprocal with the covenants on the other. What it actually meant was that the tenant had to pay the full rent so long as he had possession of the premises (level one), even though the landlord failed miserably in the delivery of services (level two).

Quinn & Phillips, *supra* note 215, at 234 (footnote omitted). Quinn and Phillips asserted that the subordination of services to possession was the source of great social injustice in landlord-tenant law. Shortly after their article, their thesis was embraced by Judge Skelly Wright in his groundbreaking *Javins* opinion, which implied a warranty of habitability into residential leases. See *Javins v. First Nat'l Realty Corp.*, 428 F.2d 1071 (D.C. Cir.), *cert. denied*, 400 U.S. 925 (1970).

This assumption also has been rejected implicitly in modern rent control legislation, which typically permits landlords to pass through to tenants periodic increases in operating costs. See generally Kenneth K. Baar, *Guidelines for Drafting Rent Control Laws: Lessons of a Decade*, 35 RUTGERS L. REV. 723, 747 (1983); Stephen Dobkin, *Confiscating Reality: The Illusion of Controls in the Big Apple*, 54 BROOK. L. REV. 1249, 1263-64 (1989); John N. Drobak, *Constitutional Limits on Price and Rent Control: The Lessons of Utility Regulation*, 64 WASH. U. L.Q. 107, 144-45 (1986); Phillip Weitzman, *Economics and Rent Regulation: A Call for a New Perspective*, 13 N.Y.U. REV. L. & SOC. CHANGE 975, 985 (1985); Scott J. Sheldon, Note, *Rethinking Rent Control: An Analysis of "Fair Return"*, 12 RUTGERS L.J. 617, 626-40 (1981).

219. See *supra* notes 213-216 and accompanying text.



presume conclusively that certain occupiers (tenants) are concerned only with the bare right of use while others (licensees) are concerned only with receipt of services. That approach demonstrates reasoning completely detached from reality. If security law is to abandon the land/services distinction, it should do so in a consistent manner, treating the income from similar projects similarly rather than drawing arbitrary distinctions based upon the imputed intentions of the occupier.

B. *Toward a New Paradigm—Treating Income from a Commercial Real Estate Project as “Proceeds” of the Project*

The problems associated with the land/services distinction raise a legitimate question whether “rent”—given its historical baggage—remains a meaningful concept to describe the revenues generated by the occupancy of commercial real estate. The courts’ rejection of the land/services distinction in the landlord-tenant context leaves the term “rent” with a meaning detached from the common law conception that “rent” springs directly from the land. Although this artificiality does not preclude security law from using “rent” as a category for classifying the revenue generated by commercial real estate, it does provide an opportunity to inquire whether a more coherent conceptual paradigm is available.

As suggested above, the developer who acquires a commercial real estate project acquires a productive capital asset with a limited useful economic life. The project will generate revenues paid by occupiers in exchange for their rights, but the project will not generate those revenues forever. The developer’s stream of future revenues represents the true economic value of the development and the mortgagee’s real collateral for repayment of the mortgage loan. Over time, the occupation of the project during its useful life consumes the project’s economic value. The payments received from the occupiers on account of their rights over the useful life of the project properly can be characterized as a return upon the project’s economic value as it is consumed. So understood, payments received from those occupiers fit squarely within the scope of the term “proceeds” as it is used in Bankruptcy Code section 552(b).

1. *The Leasing of Personal Property—Are Rentals “Proceeds”?*

To demonstrate this thesis, one first may turn to the UCC and analyze how Article 9 treats the leasing of personal property collateral. The UCC defines “proceeds” to include “whatever is received upon the sale, exchange, collection or other disposition of collateral

or proceeds.”<sup>220</sup> The concepts of “sale” and “exchange” are relatively straightforward, but unfortunately the UCC does not define “other disposition” of collateral. Intuitively, it seems plausible to characterize the temporary letting of property subject to a lien as a means of “disposition,” such that sums paid for temporary use would be characterized as “proceeds.”<sup>221</sup> Certainly, the owner of the property grants to the user certain rights of use for a term, during which the owner contractually agrees not to disturb the user in the exercise of those rights. Such a transfer of rights respecting property seems to fit squarely within any meaningful conception of “disposition.”<sup>222</sup>

Surprisingly, however, what limited case authority exists on this point has concluded that sums payable in exchange for the temporary use of property subject to a lien are not proceeds of that property under section 9-306(1). The seminal case addressing this issue is *In re Cleary Brothers Construction Co.*<sup>223</sup> The case involved General Electric Credit Corp. (“GECC”), which held a perfected first-priority security interest in a crane owned by the debtor Cleary Brothers. After its bankruptcy filing, Cleary Brothers leased the crane (without the permission or knowledge of GECC) to a third party for ten days at an agreed rent of \$10,668.<sup>224</sup> Upon learning of the lease, GECC argued that the rent constituted “proceeds” of the crane and should be applied in satisfaction of GECC’s claim.<sup>225</sup> The court disagreed, holding that “the term ‘proceeds’ does not in-

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220. U.C.C. § 9-306(1) (1987).

221. This characterization can find both support and criticism in § 9-504(1), which permits a secured party to “sell, lease or otherwise dispose of” collateral after default. U.C.C. § 9-504(1) (1972). One might argue that § 9-504(1) demonstrates that the terms “sell” and “lease” are subsumed within the concept of “disposition” by use of the word “other,” such that the leasing of property constitutes a disposition under § 9-306(1). Alternatively, one might argue that the presence of the term “lease” in § 9-504(1) demonstrates that its omission in § 9-306(1) was intentional. This alternative argument seems to have been embraced by the court in *In re Cleary Brothers Construction Co.*, 9 B.R. 40 (Bankr. S.D. Fla. 1980), the seminal case regarding this issue. See *infra* text accompanying notes 223–227.

Neither of these arguments is compelling. Instead, § 9-306(1) should be interpreted in the context of the drafters’ evolving sensitivity to economic substance over legal form. As discussed in the following text, this context suggests that the leasing of property should constitute a “disposition” within the meaning of § 9-306(1).

222. Cf. *Weisbart & Co. v. First Nat’l Bank*, 568 F.2d 391, 395 (5th Cir. 1978) (“[T]hough ‘other disposition’ cannot technically be characterized as a sale or exchange, at the minimum it must meet the threshold test of these two transactions by effecting a transfer of property.”).

223. 9 B.R. 40 (Bankr. S.D. Fla. 1980).

224. *Id.*

225. *Id.* at 41.

clude rents" paid for the use of the crane, since "[t]he words 'otherwise disposed of' related to a permanent or final conversion, not to a temporary use."<sup>226</sup> The court accordingly held that GECC had *no security interest at all* in the \$10,668 paid to the debtor. The court suggested that if GECC had wanted a lien upon such rentals, it should have taken an assignment of any leases of the crane:

Had the [drafters of the UCC] intended to extend the lenders [sic] lien to include rent from the temporary use of collateral which has been given as security, they would have included the term "leased."

This failure to do so could not have been inadvertent. The way to create a security interest in rent under the U.C.C. is to assign the lease or to give a security interest in the lease. The rent would then be the proceeds of the collateral . . . .<sup>227</sup>

Few decisions since *Cleary Brothers* have revisited this issue, and most of those decisions have agreed with *Cleary Brothers* without substantial analysis.<sup>228</sup>

The narrow conception of the words "other disposition" adopted by *Cleary Brothers* is hopelessly inconsistent with the economic realities of property leasing. The biggest concern of the secured party is the value of its collateral. A debtor-owner of encumbered property disposes of that property by disposing of its economic value. That disposition may occur by outright sale; alternatively, the debtor-owner may transfer its economic value in a piecemeal fashion by contracting away the collateral for temporary use for its useful life. For example, assume that Secured Party holds a lien upon Debtor's new computer. Unbeknownst to Secured Party, Debtor leases the computer to Lessee for \$300/month, the same amount Debtor is obligated to pay to Secured Party under its security agreement. After three months of nonpayment by Debtor, Secured Party attempts to repossess the computer and discovers that it has been leased to Lessee. When Secured Party repossesses the computer from Lessee, the computer has generated three

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226. *Id.*; see also *Mechanics Nat'l Bank v. Gaucher*, 386 N.E.2d 1052, 1055 (Mass. App. Ct. 1979) ("other disposition" as used in UCC § 9-306(1) implies a "permanent transfer of possession"). The court in *Cleary Brothers* was interpreting the 1962 version of section 9-306(1), which read slightly differently in pertinent part from the 1972 version quoted in the text. See *infra* note 234.

227. *Cleary Brothers*, 9 B.R. at 41.

228. *In re Corpus Christi Hotel Partners*, 133 B.R. 850, 856 (Bankr. S.D. Tex. 1991); *In re Investment Hotel Properties*, 109 B.R. 990, 995-96 (Bankr. D. Colo. 1990); *In re S & J Holding Corp.*, 42 B.R. 249, 250 (Bankr. S.D. Fla. 1984); *In re A.E.I. Corp.*, 11 B.R. 97, 100-02 (Bankr. E.D. Pa. 1981). *But see In re Southern Equip. Sales Co.*, 24 B.R. 788, 794 (Bankr. D.N.J. 1982) (characterizing sums paid upon leases of inventory collateral as proceeds received upon disposition of such collateral).

months' worth of contractual payments from Lessee to Debtor; to that extent, the computer's economic value to the Secured Party has been reduced. That three months' worth of economic value has been transferred to and consumed by Lessee, just as certainly as if title to collateral worth an equivalent amount had been sold by Debtor to Lessee outright. In exchange, the \$900 that Lessee paid to Debtor pursuant to the lease reflects an amount received upon the Debtor's disposition of that portion of the collateral's economic value.

A court adhering to the *Cleary Brothers* analysis would say "If Secured Party had wanted a lien upon that \$900, it should have taken an assignment of the lease. Had it done so, the lease would be its collateral, and the rentals would be proceeds of the lease."<sup>229</sup> But this merely begs the question. Why is not the lease *already* Secured Party's collateral, as "proceeds" of the computer? The debtor has disposed of a portion of the useful economic life of the computer in exchange for rights established and set forth in a contract with Lessee. The Debtor's rights as embodied in that contract are what the Debtor receives from the Lessee for transferring to the Lessee the right to use the computer. Accordingly, the Debtor's rights as embodied in that contract fit squarely within section 9-306(1)'s definition of proceeds.<sup>230</sup> In turn, the \$900 paid by Lessee on account of its contractual obligation is "proceeds of proceeds," squarely within section 9-306(1). It should be unnecessary to take an assignment of the lease solely to obtain a security interest in the rents due under that lease.<sup>231</sup>

Furthermore, the conclusion in *Cleary Brothers* that section 9-306(1) requires "a permanent or final conversion, not a temporary

229. See, e.g., *In re Investment Hotel Properties*, 109 B.R. at 995-96.

230. The UCC acknowledges this in § 9-308(b), which determines priority as between a purchaser of chattel paper (which can be a lease of goods under U.C.C. § 9-105(1)(b)) and an inventory financier. Under § 9-308(b), a purchaser of chattel paper for value in the ordinary course of business takes priority over an inventory lender who claims a security interest in the chattel paper "merely as proceeds of inventory subject to a security interest." U.C.C. § 9-308(b) (1972). For an inventory lender to have a security interest in the lease of an item of inventory collateral "merely as proceeds" of that inventory, then the lease of the item must constitute a "disposition" within the meaning of § 9-306(1). Otherwise, there would be no basis for according the inventory lender with any security interest in the chattel paper.

231. A prudent secured creditor would take an explicit assignment of the lease and would also take possession of the lease, in order to protect against the risk that a subsequent purchaser for value might take priority under § 9-308. See U.C.C. § 9-308 (1972). But that assignment would be precautionary, and is not necessary solely to create a security interest in the lease in the first instance, since the lease is "proceeds" of collateral.

use"<sup>232</sup> is equally unpersuasive. This approach effectively requires a transfer of absolute title to collateral in order for the consideration received in exchange for that transfer to constitute proceeds under section 9-306(1). Such a requirement is contrary to Article 9's general philosophy that the location of title to collateral is less significant in determining rights than the economic substance of the transaction.<sup>233</sup> The drafters have expressed this philosophy repeatedly as the UCC has evolved through amendments intended to stress economic substance over legal form. In particular, two amendments to the UCC strongly suggest that *Cleary Brothers* was decided incorrectly and that the term "disposition" in section 9-306(1) includes the leasing transaction.

The first such amendment is the 1972 revision to section 9-306(1) governing insurance payments received by a debtor following loss or destruction of the collateral. Following a casualty loss, the owner of the destroyed item still possesses nominal "title" to the item. That title is worthless, however, since the casualty has irretrievably destroyed the collateral's economic value. Following a casualty, a secured party with a lien upon the destroyed collateral understandably might look toward insurance payments received by the debtor as a substitute for the now valueless collateral. Under the 1962 version of section 9-306(1),<sup>234</sup> however, most courts concluded that the destruction of collateral via casualty was not a "disposition" of the collateral, so insurance monies payable for that casualty were not "proceeds" of the collateral subject to the secured party's lien.<sup>235</sup> In 1972, the drafters amended section 9-306(1) to

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232. *In re Cleary Brothers Constr. Co.*, 9 B.R. 40, 41 (Bankr. S.D. Fla. 1980); see also *In re S & J Holding Corp.*, 42 B.R. 249, 250 (Bankr. S.D. Fla. 1984) (cash generated through collateral "is not received from the sale of collateral, but rather, through the use of it. . . . The fact that the money was earned through the use of the collateral does not make it 'proceeds.'"); *Mechanics Nat'l Bank v. Gaucher*, 386 N.E.2d 1052, 1055 (Mass. App. Ct. 1979) ("other disposition" as used in UCC § 9-306(1) implies a "permanent transfer of possession").

233. Cf. U.C.C. § 9-202 cmt. (1972) ("The rights and duties of the parties to a security transaction and of third parties are stated in this Article without reference to the location of 'title' to the collateral.").

234. The 1962 version of § 9-306(1) provided:

"Proceeds" includes whatever is received when collateral or proceeds is sold, exchanged, collected or otherwise disposed of. The term also includes the account arising when the right to payment is earned under a contract right. Money, checks and the like are "cash proceeds". All other proceeds are "noncash proceeds".

U.C.C. § 9-306(1) (1962).

235. See, e.g., *Sanchez v. United States*, 696 F.2d 213, 215-16 (2d Cir. 1982); *Peoples State Bank v. Marlette Coach Co.*, 336 F.2d 3, 5 (10th Cir. 1964); *In re Whitacre*, 21 U.C.C. Rep. Serv. (Callaghan) 1169, 1174-75 (Bankr. S.D. Ohio 1976); *In re Parks*,

overrule these decisions, providing that “[i]nsurance payable by reason of loss or damage to the collateral is proceeds” of the collateral.<sup>236</sup> This amendment demonstrates the drafters’ apparent concern that the characterization of a particular sum as “proceeds” under section 9-306(1) should focus on whether that sum was received as compensation for some event which extracted the economic value of the collateral. If so, that sum fits squarely within the scope of the term “proceeds” as used in section 9-306(1).<sup>237</sup>

A second and more recent amendment also suggests that the leasing transaction constitutes a “disposition” of property. In 1987, the drafters amended section 1-201(37)’s definition of “security interest” in order to clarify the rules for classifying leases as either “true leases” (outside the scope of Article 9’s coverage) or disguised secured sales (subject to the provisions of Article 9).<sup>238</sup> Prior to 1987, section 1-201(37) provided little concrete guidance to courts, merely stating that the classification was to be made on a factual, case-by-case basis.<sup>239</sup> To clarify the resulting morass of conflicting

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19 U.C.C. Rep. Serv. (Callaghan) 334, 334–35 (Bankr. E.D. Tenn. 1976); *In re Waltman*, 18 U.C.C. Rep. Serv. (Callaghan) 576, 579 (Bankr. S.D. Ala. 1975); *In re Hix*, 9 U.C.C. Rep. Serv. (Callaghan) 925, 927–28 (Bankr. S.D. Ohio 1969); *In re Levine*, 6 U.C.C. Rep. Serv. (Callaghan) 238, 241 (Bankr. D. Conn. 1969); *White v. Household Fin. Corp.*, 302 N.E.2d 828, 836 n.9 (Ind. Ct. App. 1973); *Quigley v. Caron*, 247 A.2d 94, 95–96 (Me. 1968); *Third Nat’l Bank v. Continental Ins. Co.*, 446 N.E.2d 380, 382 (Mass. 1983); *In re Boyd*, 658 P.2d 470, 471–74 (Okla. 1983); *see also Bank of N.Y. v. Margiotta*, 416 N.Y.S.2d 493, 495 (Dist. Ct. 1979) (claim for damages against tortfeasor who destroyed collateral not “proceeds” of collateral); *Hoffman v. Snack*, 37 Pa. D. & C.2d 145, 146–47 (1964) (same).

236. U.C.C. § 9-306(1) (1987). The drafters noted that this sentence was “intended to overrule various cases to the effect that proceeds of insurance on collateral are not proceeds of the collateral.” PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, FINAL REPORT, Section 9-306 Reasons for Change 97–98 (1971).

237. The *Cleary Brothers* decision was governed by the 1962 version of § 9-306(1). *See In re Cleary Brothers Constr. Co.*, 9 B.R. 40, 41 (Bankr. S.D. Fla. 1980). Subsequent decisions have followed *Cleary Brothers* without analyzing whether that court would have reached the same conclusion under the 1972 version. *See, e.g., In re Corpus Christi Hotel Partners*, 133 B.R. 850, 856 (Bankr. S.D. Tex. 1991); *In re Investment Hotel Properties*, 109 B.R. 990, 995–96 (Bankr. D. Colo. 1990); *In re S & J Holding Corp.*, 42 B.R. 249, 250 (Bankr. S.D. Fla. 1984); *In re A.E.I. Corp.*, 11 B.R. 97, 100–02 (Bankr. E.D. Pa. 1981).

238. *See* U.C.C. § 1-201(37) cmt. (1987) (“The focus of the changes [to the definition of security interest] was to draw a sharper line between leases and security interests disguised as leases to create greater certainty in commercial transactions.”).

239. The pre-1987 version of § 1-201(37) provided in pertinent part:

Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional

decisions, the drafters amended section 1-201(37) to provide a more detailed definition that emphasizes the economic substance of the leasing transaction:<sup>240</sup>

Whether a transaction creates a lease or security interest is determined by the facts of each case; however, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, and

- (a) the original term of the lease is equal to or greater than the remaining economic life of the goods,
- (b) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods,
- (c) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement, or
- (d) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.<sup>241</sup>

This amendment dramatically shows the drafters' concern that economic reality rather than legal form determine the rights of parties to secured transactions.<sup>242</sup> By leasing property, the owner transfers a portion of the property's economic value to the lessee. If the terms of the lease effectively transfer the entire economic value of the property to the lessee, then section 1-201(37) treats the transaction as a sale, and the lessor must comply with Article 9 in order to perfect an interest in the property against third parties.

In recognizing that the leasing transaction involves a transfer of the property's economic value, section 1-201(37) effectively requires courts to characterize the leasing transaction as a "disposition" under section 9-306(1). A simple example illustrates this thesis. Assume that Secured Party sells two new computers to Debtor. Secured Party retains a purchase money security interest in the computers, but does not take an assignment of leases. Each computer is worth \$10,000 new, and has an expected value of

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consideration or for a nominal consideration does make the lease one intended for security.

U.C.C. § 1-201(37) (1972).

240. U.C.C. § 1-201(37) cmt. (1987).

241. U.C.C. § 1-201(37) (1987).

242. The drafters advised that this definition was intended to "focus on economics." *Id.* cmt.

\$2,000 after 36 months of use. Debtor then leases both computers—the first to Lessee #1 for \$320 per month for 36 months, with no option to purchase; the second to Lessee #2 for \$320 per month for 36 months, with an option to purchase for \$250 at the end of the lease term. In each case, the Debtor has disposed of its right to use the computers for a three-year period, during which time \$8,000 of each computer's economic value is expected to be consumed.

Under the *Cleary Brothers* analysis, Secured Party has no security interest in the \$320 per month that Debtor receives under Lease #1, since that is a true lease and Secured Party took no assignment of the lease. Lease #2 is not a true lease, however, but a secured transaction, since Lessee #2 can acquire the computer for a nominal consideration at the end of the lease term.<sup>243</sup> Since Lease #2 is in fact a sale, and since the word "sale" clearly appears in section 9-306(1), the plain meaning of that section requires the conclusion that each \$320 payment Debtor receives from Lessee #2 is "proceeds" of the computer. Thus, under *Cleary Brothers*, Secured Party has a lien upon the \$320 per month paid by Lessee #2, but not upon the \$320 per month paid by Lessee #1.

As the Permanent Editorial Board of the UCC has now recognized,<sup>244</sup> this result is absurd, because both leases—one "true," the other not—*have exactly the same effect upon Secured Party's collateral during their respective terms*. Each lease takes a portion of the economic value of the property and transfers that value to the lessee. The payments by the respective lessees represent compensation received by Debtor upon the exhaustion of that economic value. Between Debtor and Secured Party, the character of each lease as "true lease" or "disguised sale" does not change the substance of the lessee's payments. Those payments fit within the

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243. Since it is reasonably certain that Lessee #2 will capture the full economic value of the collateral, § 1-201(37) treats Lease #2 as a sale *ab initio*. See *supra* notes 241-242 and accompanying text.

244. The recently approved *PEB Commentary No. 9* provides that "[w]here a debtor has granted to a secured party a security interest in goods that the debtor later leases as lessor, the lease rentals would constitute proceeds of the secured party's collateral for the reason that the debtor's conveyance of a leasehold interest in the goods constitutes a disposition of the goods for purposes of § 9-306(1)." *PEB COMMENTARY NO. 9* (1992). Furthermore, the Article 9 Study Committee of the Permanent Editorial Board has recommended that the definition of "proceeds" in § 9-306(1) be revised in order to "make clear that when collateral consisting of goods is leased the debtor's (lessor's) leasehold interest, including the lease rentals, constitutes proceeds of that collateral." *REPORT OF PEB STUDY GROUP, UNIFORM COMMERCIAL CODE ARTICLE 9* (Dec. 1, 1992), at 106 [hereinafter *REPORT OF PEB*].



scope of the term "proceeds," just as if outright title to collateral worth that amount had passed to the respective lessees.

## 2. Letting Space in the Commercial Real Estate Development: Treating the Revenues as "Proceeds"

The foregoing analysis is equally compelling when applied to the commercial real estate mortgage transaction. As discussed in Part III, the mortgagee with a lien upon a commercial development expects a secure lien upon future property cash flows, since the discounted present value of those cash flows constitutes the economic value of the development. This concern is understandable, since the discounted present value of the future cash flows determined the amount of the mortgage loan the developer used to acquire the project.

What did a developer actually obtain when it acquired a project? The developer acquired legal title to the project, but more importantly, the developer obtained the project's productive capacity, or the exclusive right to exploit the development for commercial purposes during its useful economic life. In tangible terms, the developer obtained a finite inventory of units of space—the right to make available for occupancy  $X$  number of hotel rooms or apartments, at  $\$Y$  per term, for the project's remaining economic life of  $Z$  years. If the Shady Rest Hotel has 100 rooms and a remaining useful economic life of five years,<sup>245</sup> the developer acquires an inventory of 182,500 units, or room-nights, of space that it can sell. Likewise, if Shady Acres Apartments has 100 units and a remaining useful economic life of ten years, the developer obtains 12,000 potential unit-months of space. This inventory of space units is both the development's productive capacity and the developer's actual "product." Over time, the developer mixes its occupier services with the space and makes the units available for use under occupancy agreements (such as leases or licenses) that require the occupiers to pay compensation for their rights. When a unit of that space is consumed, that proportion of the project's productive ca-

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245. The remaining useful life of any development will be much shorter than the actual physical life of the structure. Use and occupation effects wear and tear upon the property, which will require rehabilitation (which in turn requires additional capital) in order to maintain its marketability. Further, the economic utility of a project can be impaired by functional obsolescence, or the loss of a project's "ability to be useful and to function in accordance with current market tastes and standards." Bohan & Cahill, *supra* note 166, at 65. As Bohan & Cahill have noted, hotels "are especially vulnerable to functional obsolescence when new niche products appear within or outside their own market." *Id.*; see also *supra* notes 166–171 and accompanying text.

capacity, its economic value, has been consumed. Once the entire inventory of space units is exhausted, the development's entire productive capacity has been consumed. At that point, nothing remains of the project in an economic sense—one can no longer expect the project to generate additional income for the repayment of the mortgage debt.<sup>246</sup>

Since the developer's operations will exhaust the project's economic value over time, the prudent mortgagee insists upon a first-priority assignment of the developer's right to collect project cash flows. In order to obtain the project and its productive capacity, the developer must assign to the mortgagee its rights to the project cash flows generated by the developer's sales of space over the project's useful life. Parties to these transactions may have denominated these assignments as assignments of rents and leases, as assignments of room revenues, or as assignments of accounts receivable or general intangibles, but the labels should not obscure the real nature of what is being assigned. The occupier's payment obligations in reality constitute the proceeds of the exhaustion of the development's productive capacity over time. The assignment simply reflects the parties' understanding that the mortgagee has a property interest in those revenues that constitute a return upon the economic depreciation of the project.

An agreement to occupy a commercial real estate project fits squarely within the concept of "proceeds" of the project within the meaning of section 552(b),<sup>247</sup> as do the actual payments made by

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246. The physical structure remains in existence, of course, but its ability to generate revenue based upon the initial capital investment (reflected by the mortgage debt) is exhausted. In order to acquire additional economic value, the project must be rehabilitated, which will require additional capital. That capital will not be invested unless that investment is justified by future cash flows, under the same analysis explained in Part III. Thus, any future cash flows that the project might generate after rehabilitation cannot be assumed to be a source for repayment of the original mortgage obligation.

247. Definitionally, such sums cannot constitute "proceeds" under UCC § 9-306(1); Article 9 defines "collateral" as "property subject to a security interest," U.C.C. § 9-105(1)(c) (1987), and one cannot create a "security interest" in land. *Id.* §§ 1-201(37), 9-102(1), 9-104(j). This definitional trap would require bankruptcy courts to define the term "proceeds" in Bankruptcy Code § 552(b) more broadly than the term is used in UCC § 9-306(1). There is legislative history in support of this view. *See* H.R. REP. NO. 595, 95th Cong., 1st Sess. 377 ("The term 'proceeds' [as used in § 552(b)] is not limited to the technical definition of that term in the U.C.C., but covers any property into which property subject to the security interest is converted."); *id.* at 368 ("Proceeds here [in § 541(a)'s definition of property of the estate] is not used in a confining sense, as defined in the Uniform Commercial Code, but is intended to be a broad term to encompass all proceeds of property of the estate."); S. REP. NO. 989, 95th Cong., 2d Sess. 83 (same). In addition, bankruptcy courts have used this legislative history to give the term "proceeds" a broader definition than the UCC definition. *See, e.g.,* *Bradt v.*

occupiers pursuant to those agreements. Contrary to the conventional wisdom of the hotel bankruptcy cases, Congress did not intend to include sums such as postpetition hotel room revenues within the scope of section 552(a). Congress's purpose in adopting section 552(a) was to defeat the postpetition application of an after-acquired property clause in a prepetition security agreement, thereby cutting off a secured party's floating lien as of the date of bankruptcy.<sup>248</sup> Postpetition rents or hotel revenues, however, are not the classic type of after-acquired property that Congress intended section 552(a) to reach. The classic floating lien involves a pool of collateral of a certain type, such as inventory, in which a secured party has a lien. As the debtor sells old inventory in the course of its business operations, new items of inventory are acquired to which the secured party's floating lien immediately attaches. The mortgagee's lien upon rents or hotel revenues is different in kind from a floating lien. When a developer acquires a project, it acquires the project *and its future productive capacity*. As that capacity is consumed over time by occupiers, the developer adds no new capacity over which the mortgagee's lien can "float."

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Woodlawn Auto Workers, F.C.U., 757 F.2d 512, 515 (2d Cir. 1985) (insurance payment for repair of debtor's car constituted proceeds of debtor's car); *In re Judkins*, 41 B.R. 369, 372 (Bankr. M.D. Tenn. 1984) (payment-in-kind contracts under federal crop diversion program are proceeds of farmer's crop, even if crop was never planted); *In re Cupp*, 38 B.R. 953, 955 (Bankr. N.D. Ohio 1984) (same); *In re Sunberg*, 35 B.R. 777, 783-84 (Bankr. S.D. Iowa 1983) (same), *aff'd*, 729 F.2d 561 (8th Cir. 1984).

Other courts have rejected the language in the legislative history, concluding that "proceeds" as used in § 552(b) has the same meaning and scope as in § 9-306(1). *See, e.g., In re Bumper Sales, Inc.*, 907 F.2d 1430, 1437 (4th Cir. 1990) (§ 552(b)'s reference to "applicable nonbankruptcy law" means that extent of creditor's security interest in proceeds governed by UCC § 9-306); *In re Hugo*, 58 B.R. 903, 907 (Bankr. E.D. Mich. 1986) (same); *In re Transportation Design & Technology, Inc.*, 48 B.R. 635, 641 (Bankr. S.D. Cal. 1985). None of these cases, however, have involved real property collateral. Absent some indication that Congress intended to limit the application of the term "proceeds" solely to personal property, it seems sensible to conclude that sums received upon the disposition of real property collateral would constitute "proceeds" under § 552(b).

248. *See* H.R. REP. NO. 595, 95th Cong., 1st Sess. 376 ("As a general rule, if a security agreement is entered into before the case, then property that the estate acquires is not subject to the security interest created by the security agreement."); S. REP. NO. 2266, 95th Cong., 2d Sess., at 91 (same).

In explaining § 552(a) to students, I analogize § 552(a) to the chalk line that the police draw around the body of a crime victim. Bankruptcy renders the debtor "dead," and § 552(a) draws a chalk line around the property belonging to the debtor on that date. If a secured party has a validly perfected prepetition security interest in "furniture," every item of furniture within that chalk line is subject to the secured party's lien. But if the debtor-in-possession acquires new furniture the following week, that new furniture is not placed within the chalk line; instead, the debtor-in-possession takes that new furniture free of the secured party's lien. *But see infra* note 249.

Instead, postpetition rents or hotel revenues fall squarely within the parameters of section 552(b). Congress intended section 552(b) to secure to the mortgagee its prepetition collateral *and the collateral's future productive capacity*.<sup>249</sup> Thanks to section 552(b), a debtor cannot use, consume, or dispose of prepetition collateral or its productive capacity to the detriment of the secured party's lien. When the developer provides space to temporary occupiers, the developer in fact uses the mortgaged collateral in a fashion that consumes its productive capacity and its economic value over time. The sums received by the developer in exchange for that consumption—regardless of whether state law characterizes them as common law “rent”—plainly constitute the fruits of the developer's use and the proceeds of the consumption of the secured party's collateral. Accordingly, one properly can characterize the income generated by the letting of space as “proceeds” of the underlying mortgage collateral within the scope of section 552(b), and thus give weight and effect to the realities underlying commercial real estate financing transactions.<sup>250</sup>

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249. This should be apparent from § 552(b)'s language, which protects the secured party's rights in the “proceeds, product, offspring, rents, or profits” of prepetition collateral. 11 U.S.C. § 552(b) (1987). The clear thrust of this provision is to protect the secured party against the risk that its prepetition collateral is disposed of or used in a manner that consumes its value to the detriment of the secured party's interest. For example, suppose that a debtor-in-possession disposes of prepetition collateral and uses the proceeds to acquire new collateral of the same type? The new collateral is after-acquired property, but it is also “proceeds” under UCC § 9-306(1), and the secured party maintains its lien against the new collateral under § 552(b). *See, e.g., In re Bumper Sales, Inc.*, 907 F.2d 1430, 1436–39 (4th Cir. 1990) (§ 552(b) protects secured party's lien against second generation proceeds of prepetition collateral notwithstanding § 552(a)).

250. Several hotel bankruptcy decisions have held that postpetition hotel room revenue is generated by the debtor's provision of postpetition services and thus cannot constitute “rents” or “proceeds” under § 552(b). *See Averch, supra* note 6, at 496–501 (discussing cases). The fact that the developer's services occur postpetition is irrelevant. First, those services are an inextricable part of the developer's product—available space for temporary occupancy. *See supra* notes 213–216 and accompanying text. Second, prepetition collateral of any kind, whether real or personal, does not simply liquidate itself upon the commencement of a bankruptcy. The debtor must *always* undertake additional labor services to liquidate prepetition collateral, yet that fact does not transform the sums generated by that liquidation into something other than proceeds of the collateral. Future rents, hotel room revenues, or any other sums paid by occupiers of land “require the contribution of additional acts or services [by the developer] in order to come into being.” *In re Northview Corp.*, 130 B.R. 543, 548 (Bankr. 9th Cir. 1991); *see also In re Prichard Plaza Assocs. Ltd. Partnership*, 84 B.R. 289, 298 (Bankr. D. Mass. 1988) (“Rents . . . do not spring from the ground. Real estate must be maintained and serviced to produce them, much as a contract must be performed to bring payment under it.”).

C. *Article 9 as a Superior Conceptual Framework for the Assignment of a Security Interest in Rents*

As discussed above, the developer's right to payments under its contracts with occupiers constitutes proceeds of the development as the occupiers consume its economic value over time. Since it is the developer's right to this stream of contract payments that is the primary focus of the developer/mortgagee bargain, the developer's assignment of that right can be characterized as an assignment of an interest in personal property rather than an assignment of an interest in real estate. This characterization would allow property security law to use Article 9 as a framework for the creation, perfection, and enforcement of any security interest in the revenue generated by occupation of commercial real estate.

The appropriateness of Article 9 for this task is apparent when one considers how security law currently treats assignments of installment land contracts. Assume that *O*, owner of Blackacre in fee simple absolute, sells Blackacre to *P* via an installment land contract. Subsequently *O* needs cash and borrows money from *M*, assigning to *M* its rights in Blackacre to secure the loan. If *M* is prudent, *M* will take both an assignment of *O*'s record title and an assignment of *O*'s rights under the land contract—particularly, *O*'s right to payment of each installment when due. Clearly, *M* may record the assignment of *O*'s record title upon the real property records, but what about the assignment of the installment contract rights? Theoretically, we could treat this as an assignment of an interest in land (such that *M* must record the assignment on the realty records) or an assignment of an interest in personalty (such that *M* must provide notice to third parties by filing a UCC financing statement). The overwhelming trend in the courts, however, is to treat the assignment of the vendor's interest under an installment land contract as an assignment of an interest in personal property subject to the provisions of Article 9.<sup>251</sup> As the Ninth Circuit re-

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251. See, e.g., *In re Heide*, 915 F.2d 531, 533–34 (9th Cir. 1990) (applying Washington law); *In re Equitable Dev. Corp.*, 617 F.2d 1152, 1155–57 (5th Cir. 1980) (applying Florida law); *In re I.A. Durbin, Inc.*, 46 B.R. 595, 599 (Bankr. S.D. Fla. 1985); *In re Northern Acres, Inc.*, 52 B.R. 641, 644–47 (Bankr. E.D. Mich. 1984); *In re D.J. Maltese, Inc.*, 42 B.R. 589, 591–92 (Bankr. E.D. Mich. 1984); *In re Southern*, 32 B.R. 761, 764–65 (Bankr. D. Kan. 1983); *In re S.O.A.W. Enters., Inc.*, 32 B.R. 279, 284–86 (Bankr. W.D. Tex. 1983); *In re Gemini at Dadeland Ltd.*, 24 B.R. 57, 58 (Bankr. S.D. Fla. 1982); *In re Southworth*, 22 B.R. 376, 378–79 (Bankr. D. Kan. 1982); *Citicorp Person-to-Person Fin. Ctr., Inc. v. Fremont Nat'l Bank*, 738 P.2d 29, 31–32 (Colo. Ct. App. 1987); *Security Bank v. Chiapuzio*, 747 P.2d 335, 336–43 (Or. 1987); *Crichton v. Himlie Properties, Inc.*, 713 P.2d 108, 110 (Wash. 1986); *In re Freeborn*, 617 P.2d 424,

cently noted, “[t]he vendor’s right to receive payments under the contract is a personal property right; therefore, Article 9 governs the assignment of a vendor’s right to receive those payments.”<sup>252</sup>

In evaluating the interests transferred by assignment of an installment land contract, security law thus has separated the vendor’s interest in the land itself from the vendor’s contractual right to receive installment payments. To this extent, the installment land contract can be analogized to and contrasted with the lease. The vendee’s promise to perform an installment land contract gives the vendee an interest in land; similarly, the lessee’s promise to perform the terms of its lease gives the lessee an interest in land. While the vendor’s contract rights bear a close relationship to the land, the trend of authority in property security law treats the vendor’s contract rights as separable from the land, designating them as personal property collateral in the nature of general intangibles.<sup>253</sup> This classification is not arbitrary; it reflects commercial reality by recognizing that the assignee’s primary concern in taking the assignment is to obtain security in the vendee’s installment payments.

Accordingly, the decision to include the assignment of an installment land contract vendor’s rights within Article 9 stands in stark contrast to Article 9’s exclusion of assignments of leases and rents. The final version of section 9-104(j), approved in 1958, excluded assignments of leases and rents from Article 9’s otherwise sweeping coverage, apparently to avoid objections from the real estate bar and thereby facilitate the UCC’s passage. Removed from its political genesis,<sup>254</sup> however, the UCC’s exclusion of leases and

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427–29 (Wash. 1980). *Contra In re Shuster*, 784 F.2d 883, 884–85 (8th Cir. 1986) (applying Minnesota law); *In re Hoepfner*, 49 B.R. 124, 127–29 (Bankr. E.D. Wis. 1985).

252. *In re Heide*, 915 F.2d 531, 533 (9th Cir. 1990) (interpreting Washington law).

253. Section 9-106 defines “general intangibles” as “any personal property (including things in action) other than goods, accounts, chattel paper, documents, instruments, and money.” U.C.C. § 9-106 (1972).

The Permanent Editorial Board Article 9 Study Group has now recommended that Article 9 be revised to codify this position. REPORT OF PEB, *supra* note 244, at 66 (“Article 9 should be revised to make clear that perfection of a security interest in a vendor’s rights under an installment land contract is governed by Article 9, that perfection should be accomplished in the same manner as with any other right to payment, and that no additional perfection is required with respect to the vendor’s interest in the subject real property.”).

254. Even Grant Gilmore described § 9-104’s exclusions as a “curiously compiled list [that] defies rational analysis.” 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY, § 10.7, at 312 (1965). As Gilmore noted, many of the § 9-104 exclusions reflect “what might be described as politically inspired concessions by the Code sponsors to interests which, for good or bad or no reasons, did not want transactions in which they were involved covered by a newfangled statute.” *Id.*

rents is more puzzling. Analytically, the assignment of a lease can easily be separated into real and personal property components, as security law has done with the installment land contract. Security law could characterize the assignment of a lease as transferring both an interest in realty (the lessor's reversionary interest in the land) and an interest in the lessor's contractual rights under the lease (including the lessor's right to collect the lessee's contractual payments). But for the sheer historical weight of the common law conception that rent "issues from the land," the lessor's contractual rights under the lease could be characterized as an interest in the nature of personality.

The time has arrived for security law to discard this historical baggage. This Article previously demonstrated that security law uses the term "rent" in an artificial manner removed from its pure common law conception as an obligation that springs from the land.<sup>255</sup> Thus, the manner in which security law characterizes the revenue generated by a development ought to be informed not by outmoded common law conceptions, but by the behavior of the parties to the financing transaction. At the planning stage, the developer and mortgagee evaluate the development transaction in terms of projected future cash flows generated by occupancy contracts, without regard to the legal characterization of those cash flows.<sup>256</sup> This fact is critical to a meaningful understanding of the term "rents and profits" as parties use that term in the commercial real estate financing transaction. As Tiffany recognized in his treatise on landlord and tenant, the term "rent" has at least four distinct uses. First, "rent" abstractly may describe any and every sum payable by any person having an interest in land ("Rents are high because the market is tight"). Second, "rent" may describe a particular obligation to be made by an occupier of particular land ("X's rent is overdue"). Third, "rent" can describe the right of a particular person to a payment or succession of payments by the occupant of a particular parcel of land ("Y has a rent of \$500 per month on Blackacre, which she leased to X"). Fourth, "rent" may designate the proceeds of the occupier's legal obligation ("I just deposited \$10,000 of rent paid by Y").<sup>257</sup> When the mortgagee takes an assignment of "rents and profits," the mortgagee's primary objective is to secure the "rent" in this fourth sense, as the cash flow

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255. See *supra* note 217 and accompanying text.

256. See *supra* notes 155-171 and accompanying text.

257. 1 TIFFANY, *supra* note 56, § 165, at 1009-10.

or the proceeds of the occupier's obligation.<sup>258</sup> In the commercial land financing transaction, the practical significance of a collateral assignment of rents and profits is to express clearly that the mortgagee receives a security interest in project cash flows from the closing of the financing transaction through the completion of a foreclosure and the extinguishment of the owner's equity of redemption in the development.<sup>259</sup> Since the length of time necessary to extinguish the owner's equity of redemption may be significant (and since it may be extended indefinitely by the owner's bankruptcy), a collateral assignment of rents and profits protects the security of the mortgagee both in (a) cash flows that have accrued prior to default and (b) cash flows that will accrue between default and completion of a foreclosure.<sup>260</sup>

With respect to rents already accrued, there is ample common law authority for the proposition that they constitute personal property.<sup>261</sup> With respect to unaccrued rents, the common law histori-

258. See *id.* at 1010 ("The word [rent] is frequently used in this sense in the phrase 'rents and profits.'").

259. By obtaining and enforcing this interest, the mortgagee can prevent the mortgagor from "milking" the property, or engaging in

a combination of aggressive rent collection efforts, minimal maintenance, tax delinquency, low purchase down payments, and delinquency in paying off . . . mortgages [which] can permit an owner to make a handsome profit for a limited time, even as he writes off a larger portion of the rent roll and depreciates the asset value of the property to zero by walking away from his building when its economic potential is exhausted.

PETER D. SALINS, *THE ECOLOGY OF HOUSING DESTRUCTION* 14 (1980); see also NELSON & WHITMAN, *supra* note 199, § 4.42, at 250-51 ("milking" is siphoning off project cash flows for benefit of developer without maintaining property and paying mortgage debt).

260. This is not to suggest that an assignment of rents and leases serves no other purpose, or that a mortgagee does not care about the security of its right to collect revenues after foreclosure is completed. Still, unless the developer previously has assigned away the right to collect unaccrued rents and profits, that right passes to the mortgagee along with title upon the completion of the foreclosure. See NELSON & WHITMAN, *supra* note 199, §§ 4.20-4.23, at 192-200. If the developer previously assigned away its right to collect unaccrued revenues, no prudent mortgagee will make a first-priority mortgage loan against the development. Accordingly, the *primary* significance of the assignment of rents, as a contractual matter, is to protect the mortgagee's security in the project cash flows prior to extinguishment of the developer's equity of redemption.

261. See, e.g., 49 AM. JUR. 2D *Landlord and Tenant*, §§ 515, 530, at 495, 512 & n.16 (1970 & Supp. 1992) (collecting cases holding that accrued rents represent a chose in action, are personal property, and do not pass to a transferee of reversion absent contrary agreement); 2 AMERICAN LAW OF PROPERTY § 9.41, at 455 (A. James Casner ed., 1952) (same); see also *Marine Nat'l Bank v. Northwest Pa. Bank & Trust Co.*, 454 A.2d 67, 70 (Pa. Super. Ct. 1982) ("The right to *accrued* rents is a personal property right.").



cally has treated them as an interest in land.<sup>262</sup> But why should security law characterize the tenant's payment obligation for its interest in land as realty, yet classify the installment contract vendee's obligation for its interest in land as personalty?<sup>263</sup> Since the mortgagee intends the term "rents and profits" to describe the proceeds of the occupier's *contractual* obligation, it seems ridiculous to characterize those revenues as realty based solely upon the outmoded construct that rent issues directly from land.

By focusing upon the economic realities of the modern commercial real estate financing transaction, security law can provide a coherent conceptual basis for treating the income generated by a commercial development as personalty when pledged to secure the underlying mortgage indebtedness.<sup>264</sup> Incorporating income paid for the use of land into Article 9's framework for creating and perfecting security interests can provide much-needed transactional uniformity to commercial land finance.<sup>265</sup> Furthermore, including

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262. See, e.g., 49 AM. JUR. 2D *Landlord and Tenant*, §§ 515, at 495 (1970) (collecting cases holding that unaccrued rents are realty that pass with a transfer of reversion); 2 AMERICAN LAW OF PROPERTY, *supra* note 261, § 9.41, at 455 (same); see also *Marine Nat'l Bank*, 454 A.2d at 70 ("The right to *unaccrued* rents is, however, an 'incorporeal hereditament' and part of the reversionary real property.").

263. See *supra* notes 251-253 and accompanying text.

264. At least one other commentator has expressly analogized rents to accounts receivable. See Sally A. Conti, *Assignments of Rent in Bankruptcy: There Is Hope for Secured Creditors*, NORTON BANKR. L. ADVISER, May 1991, at 7, 9-10. Unfortunately, the UCC provides a definitional obstacle. An account is "any right to payment for goods sold or leased or for services rendered which is not evidenced by an instrument or chattel paper." U.C.C. § 9-106 (1987). A hotel room does not fit within the UCC definition of "goods," which is limited to movables and fixtures. *Id.* § 9-105(1)(h). Furthermore, unless 100% of the occupier's payment is allocated to services received (or unless "services" is interpreted to include the provision of land for temporary occupancy), the occupier's entire payment would not fall within the definition of account. Accordingly, the occupier's payment is best characterized as a "general intangible" under § 9-106, consistent with the UCC's current classification of a vendor's right to installment land contract payments. See *supra* notes 251-253 and accompanying text.

265. Previous efforts to achieve uniformity in state real estate finance laws have failed miserably. The National Conference of Commissioners on Uniform State Laws have proposed a number of uniform acts—the Uniform Real Estate Mortgage Act (1927), the Model Power of Sale Foreclosure Act (1940), the Uniform Land Transactions Act (1977), and the Uniform Land Security Interest Act (1985)—yet none has been enacted by any state. See Michael H. Schill, *Uniformity or Diversity: Residential Real Estate Finance Law in the 1990s and the Implications of Changing Financial Markets*, 64 S. CAL. L. REV. 1261, 1278-79 (1991).

Further, incorporating payments made by occupiers of land into Article 9 would provide much needed uniformity in the bankruptcy context. For example, there has been a tremendous amount of confusion in the bankruptcy courts as to when a mortgagee's security interest in rents is "perfected." This confusion has triggered a senseless debate, with some courts concluding that a mortgagee perfects by duly recording its

such income within the scope of Article 9 is consistent with the UCC drafters' expressed objective to adhere to substance over form in the governance of secured transactions. As the drafters noted, the objective of Article 9 was "to make distinctions, where distinctions are necessary, along functional rather than formal lines."<sup>266</sup> Viewed in hindsight, the drafters' decision to exclude rents gives significance to form rather than function, contrary to this objective. Those charged with revising Article 9 should remove section 9-104(j)'s exclusion of rents pledged as security, and should instead treat the developer's right to payments made by occupiers of land as a general intangible subject to the provisions of Article 9.<sup>267</sup>

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assignment of rents on the realty records, while others conclude that a mortgagee must actually take possession of the realty after default in order to perfect its lien. Compare *In re Village Properties, Ltd.*, 723 F.2d 441, 443-47 (5th Cir.), cert. denied, 446 U.S. 974 (1984) (security interest in rents unperfected where mortgagee had not obtained possession of property, impounded rents, or secured appointment of receiver) and *In re Prichard Plaza Assocs. Ltd. Partnership*, 84 B.R. 289, 293-97 (Bankr. D. Mass. 1988) (same) with *In re Vienna Park Properties*, 976 F.2d 106, 112-14 (2d Cir. 1992) (security interest in rents perfected upon recording of assignment of rents) and *In re Raleigh/Spring Forest Apartments Assocs.*, 118 B.R. 42, 44-45 (Bankr. E.D.N.C. 1990) (same); see also Averch, *supra* note 6, at 485 n.3 (collecting dozens of cases on either side of this debate). Requiring the mortgagee to take possession of the realty in order to perfect its lien misapprehends the distinction between the creation and perfection of a lien and the enforcement of that lien against the collateral—a distinction that is clearly expressed and understood in the UCC. Had § 9-104(j) not excluded assignments of leases and rents from Article 9, none of this senseless debate—the primary effect of which has been to reallocate wealth from owners, mortgagees, and unsecured creditors to bankruptcy lawyers—would have been necessary.

266. The drafters intended Article 9 "to provide a simple and unified structure within which the immense variety of present-day secured financing transactions can go forward with less cost and with greater certainty." U.C.C. § 9-101 cmt. (1972). One purpose for this unitary approach was to simplify the complex hodgepodge of state security laws governing each type of lien, which imposed "increasing costs to both parties and increasing uncertainty as to their rights and the rights of third parties dealing with them." *Id.*

267. Regrettably, a majority of the Permanent Editorial Board's Advisory Group on Real Estate-Related Collateral has recommended that Article 9 not be amended to incorporate security interests in real estate rents. The report suggested the following reasons for this recommendation:

- (1) such an amendment would frustrate otherwise feasible real estate reorganizations;
- (2) it would be unfair to allow a party to collect rents if they have no responsibility to maintain the property;
- (3) there are potential problems coordinating the lender's remedies as a secured party with the lender's remedies as a mortgagee;
- (4) there is a reluctance to inject Article 9 into an area historically dominated by real property law;
- (5) such an amendment would meet strong political opposition from interest groups that would delay the enactment of needed amendments to Article 9.

## CONCLUSION

The conceptual formalism displayed by the bankruptcy courts in the hotel bankruptcy cases is unsatisfactory both as a matter of

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REPORT OF PEB, *supra* note 244, app. at 154-55, 196. A minority of the Advisory Group recommended that Article 9 should be revised to include "rents" within its scope. *Id.*

These justifications do not withstand careful scrutiny. The first objection (frustration of feasible reorganizations) is directed to the wrong forum. Inclusion of rents within Article 9 would not by itself doom otherwise feasible real estate reorganizations. As discussed previously, real estate reorganizations must rise or fall on their own merits under the standards set forth in the Bankruptcy Code. *See supra* notes 184-186 and accompanying text. If proper characterization of rents as Article 9 collateral would make single asset real estate bankruptcy cases more difficult to sustain, that is a bankruptcy matter—not a UCC concern—and a matter more appropriately addressed to Congress.

The second objection (mortgagees could collect rents without maintaining the land) makes an assumption that is plainly wrong. Where is it written that a lender with a security interest in rents can take the gross rents from a project without regard for maintaining the property? Lenders write mortgage loans on the assumption that net cash flow after operating expenses will be available to secure repayment of the mortgage. *See supra* notes 155-171 and accompanying text. If the mutual understanding of developer and mortgagee is that gross rentals are to be dedicated to maintaining the property, security law certainly can condition the mortgagee's enforcement of its security interest upon maintenance of the property. Furthermore, bankruptcy courts generally will allow the debtor-in-possession to use rents to pay operating expenses on the ground that payment of these expenses preserves the going-concern value of the property and thus provides adequate protection of the mortgagee's interest in the property. *See supra* note 184 and accompanying text. Finally, the suggestion that a commercial mortgagee would consciously fail to maintain the property and allow it to deteriorate, thereby destroying the value of its own collateral, seems spurious.

The third objection (coordination of the mortgagee's Article 9 and real estate remedies) seems trivial. While there may be potential problems in coordinating a lender's remedies as an Article 9 secured party with its remedies as a mortgagee, the UCC has drafted around such problems in the past. *See, e.g.*, U.C.C. § 9-504(1) (1982) (where security agreement covers both land and personal property, secured party may choose to sell personal property collateral under Article 9 or in foreclosure sale under real estate law). Likewise, the fourth objection (rents have always been real estate collateral) is uninspired. Yes, rent historically has been within the purview of real estate law, but that fact hardly justifies continuing adherence to an outmoded concept that now obscures and complicates the proper analysis of commercial transactions. *Cf.* U.C.C. § 9-101 cmt. (1972) (discussing why Article 9 abandoned traditional distinctions among pre-UCC security devices such as chattel mortgages and trust receipts and replaced them with broader and more functional term "security interest").

The fifth objection (the proposed amendment would meet strong opposition from various interest groups, risking delay in the enactment of the Article 9 reforms) is entirely understandable yet completely unsatisfactory. First, the risk of disagreement seems an inappropriate basis upon which to cease debate. Second, if political opposition to this proposal would threaten the passage of other necessary amendments, the Permanent Editorial Board should sever this issue from the remaining unobjectionable amendments and discuss this proposal in greater detail. Finally, if the Permanent Editorial Board is concerned about the political clout of developers and the Chapter 11 bar, anecdotal evidence of state legislative activity suggests that this concern may be misplaced.

law and logic. As the American Law Institute has suggested in the proposed *Restatement (Third) of Property-Security (Mortgages)*, there is no legal or functional basis for bankruptcy courts to treat hotel room revenues (and other sums paid in exchange for the right to occupy land) differently from rents paid by tenants holding leasehold estates in land.<sup>268</sup> In administering distressed hotel projects, bankruptcy courts should reject the “tenant vs. licensee” distinction previously embraced by the hotel bankruptcy cases and should instead treat the hotel mortgagee identically with mortgagees of tenant-based commercial land developments.

While the proposed *Restatement’s* definition of “rents” is a vast improvement over the conceptual formalism of the bankruptcy courts, it does not resolve the larger question whether the term “rent” has continuing usefulness as a basis for categorizing the income generated by commercial real estate. The historical common law distinction that sums paid for the bare use of land are rent, while sums paid for services are not rent, no longer provides a principled basis for characterizing the sums paid by occupiers of commercial real estate projects. These projects involve an inextricable blend of land and services, both of which are essential parts of the developer/occupier bargain.<sup>269</sup> Instead, sums paid by occupiers of a project during its useful economic life reflect a return upon the diminution of the project’s productive capacity as that capacity is exhausted over time. Accordingly, those sums constitute proceeds of the underlying real estate collateral and should be protected under Bankruptcy Code section 552(b) to the same extent as the mortgagee’s lien against the real estate collateral.<sup>270</sup> Furthermore, there remains no sensible basis upon which to categorize “rent” as an interest fundamentally in the nature of realty. All income generated pursuant to contracts for the occupancy of land should be characterized as personal property when that income is pledged as

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Ten states already have enacted statutes establishing that a creditor’s lien upon rents is “perfected” when the creditor records its assignment of rents on the real estate records, thereby incorporating the UCC concept of “perfection” into the law of rents and making single asset Chapter 11 cases more difficult to sustain. *See, e.g.*, CAL. CIV. CODE §§ 2938, 2938.1 (West 1993); FLA. STAT. ANN § 697.07 (West Supp. 1993); KAN. STAT. ANN § 58-2343 (Supp. 1992); LA. REV. STAT. ANN. § 9:4401 (West 1991); MD. REAL PROP. CODE ANN. § 3-204 (Sup. 1992); N.C. GEN. STAT. § 47-20(c) (Supp. 1992); OR. REV. STAT. § 93.806 (1991); TENN. CODE ANN. § 66-26-116 (Supp. 1992); VA. CODE ANN. § 55-220.1 (Michie Supp. 1992); WASH. REV. CODE ANN. § 7-28-230(3) (West 1992).

268. *See supra* Parts II–III.

269. *See supra* notes 192–219 and accompanying text.

270. *See supra* notes 220–250 and accompanying text.

security, and liens upon that income should be subject to the provisions of UCC Article 9.<sup>271</sup>

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271. *See supra* notes 251–267 and accompanying text.