SO ORDERED.

SIGNED this 27th day of March, 2013.

Janice Miller Karlin
United States Bankruptcy Judge

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS

In re:
HD Gerlach Company, Inc.,

Debtor.

Case No. 12-40685
Chapter 11

Order Granting Second Motion to Use Cash Collateral

This chapter 11 bankruptcy petition was filed on May 9, 2012 by Debtor HD Gerlach Company, Inc. ("HD Gerlach Co."). This matter is before the Court on HD Gerlach Co.'s second motion to use cash collateral, which is opposed by Creditor Central National Bank.[1] The parties filed a joint stipulation of facts, and have fully briefed the issue.[2] Because 11 U.S.C. § 541(a)(6) definitively states that the "proceeds, product, offspring, rents, or profits of or from property of the estate" are considered

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[1] Doc. 107 (Debtor's second motion to use cash collateral); Doc. 123 (objection of Central National Bank).

[2] Doc. 161 (joint stipulation of facts with exhibits); Doc. 182 (opening brief of Central National Bank); Doc. 194 (response brief of HD Gerlach Co.); Doc. 200 (reply brief of Central National Bank).

property of the bankruptcy estate, the Court grants Debtor's second motion to use cash collateral.

Factual and Procedural History

Debtor owns and operates an apartment complex commonly known as Wanamaker 22 Apartments. Central National Bank is a secured creditor of the Debtor by virtue of a promissory note dated September 10, 2010. The promissory note is secured by, among other things, a properly recorded real estate mortgage executed by Debtor on Wanamaker 22 Apartments. Central National Bank obtained an appraisal of the Wanamaker 22 Apartments on August 24, 2010, which estimated the as-is market value of the property to be $2,020,000.

In addition to the promissory note and mortgage, Debtor executed two assignment of rent agreements relating to the Wanamaker 22 Apartments: the first on April 2, 1992, and the second on September 10, 2010. Both assignments were properly recorded. The 1992 assignment of rents states it was entered "as further security for the payment of the indebtedness and performance" of the agreements secured by the parties' mortgage.[3]

The second assignment was also entered "in consideration of the loan" entered between Central National Bank and Debtor.[4] The second assignment of rents further states, in pertinent part:

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[3] Doc. 161 Exh. C at p.1.

[4] Doc. 161 Exh. C at p.11.

1. ASSIGNMENT. . . . Grantor absolutely assigns to Lender all of Grantor's interest in the leased and tenancy agreements . . . now or hereafter executed . . ., including all rents, income, and other profits . . . .

. . .

2. PAYMENT TO LENDER. Upon a default . . . , Lender may provide notice to Grantor that all rents, income and profits arising from the Leases . . . shall be paid directly to Lender or its named designee and applied to the payment of interest and principal owing Lender or Grantor's Indebtedness to Lender.

. . .

6. DEFAULT AND REMEDIES. Upon default . . ., Lender may at its option take possession of the Real Estate and the Improvements thereon and have, hold, manage, lease and operate the premises on terms and for a period of time that Lender deems proper. Lender may continue to collect and receive all rents, income and profits from the Real Estate, and Lender shall have full power to periodically make alterations, renovations, repairs or replacements to the premises as Lender may deem proper. Lender may apply all rents, income and profits to the payment of the cost of such alterations, renovations, repair and replacements and any expenses incident to taking and retaining possession of the Real Estate and the management and operation of the Real Estate. Lender may keep the Real Estate properly insured and may discharge any taxes, charges, claims, assessments and other lien which may accrue. . . .

. . .

9. INDEPENDENT RIGHTS. This Assignment and the powers and rights granted are separate and independent from any obligation contained in the Mortgage and may be enforced without regard to whether Lender institutes foreclosure proceedings under the Mortgage. This Assignment is in addition to the Mortgage and shall not affect, diminish or impair the Mortgage. However, the rights and authority granted in this Assignment may be exercised

in conjunction with the Mortgage.[5]

On December 14, 2011, Central National Bank notified Debtor that the indebtedness owed under the promissory note had been accelerated. Thereafter, on March 28, 2012, Central National Bank instructed each tenant of the Wanamaker 22 Apartments to pay their monthly rent directly to Central National Bank. In addition, on March 28, 2012, Central National Bank notified Debtor's counsel of the delivery of the tenant notifications, and also filed a lawsuit in state court against Debtor and its principals, Harold and Paula Gerlach.

This lawsuit sought foreclosure of both the mortgage on Wanamaker 22 Apartments and of Central National Bank's security interest in certain personal property collateral owned by the Gerlachs. On April 24, 2012, all parties to the lawsuit entered into an agreed order appointing Associated Management Services as the property manager of the Wanamaker 22 Apartments. Central National Bank never requested the appointment of a receiver in the foreclosure proceedings.

On May 9, 2012, Debtor filed its voluntary Chapter 11 bankruptcy petition. The same day, Debtor filed a motion for turnover of the rents collected prepetition, a motion for authorization to use all rents (both pre and postpetition) as cash collateral, and a motion to approve rejection of executory contract. On June 7, 2012, an agreed order was entered resolving these motions, and temporarily authorizing Debtor's use of rents from the Wanamaker 22 Apartments until November 5, 2012. Under the agreed order,

[5] Doc. 161 Exh. C at pp.11–13.

Debtor made five adequate protection payments to Central National Bank, each for $11,500.

When the authorized period to use rents was about to expire, on October 30, 2012, Debtor filed the second motion to use cash collateral that is the subject of the current dispute.[6] Central National Bank objected to the motion,[7] and the Court conducted its first hearing on the motion on December 18, 2012. At that hearing, the Court allowed Debtor to use cash collateral with the same terms as the parties' prior cash collateral order, and continued the hearing on the motion to January 9, 2013.[8] At the January 9 hearing, the Court required the parties to brief the cash collateral motion, required Debtor to make monthly adequate protection payments of interest in the interim, and implemented monthly reporting requirements.[9] The parties thereafter agreed on the amount of the interim interest payment, but ultimately not on the date the first payment was due, and a subsidiary round of motions ensued.[10] The Court was

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[6] Doc. 107.

[7] Doc. 123.

[8] Doc. 143.

[9] Doc. 172. The parties could not agree on an order reflecting the terms discussed at the conclusion of the January 9, 2013 hearing, so the Court drafted and entered an order on February 11, 2013.

[10] *See* Doc. 181 (Central National Bank's motion to prohibit further use of rents); Doc. 183 (Debtor's objection to Central National Bank's motion to prohibit further use of rents); Doc. 184 (Debtor's motion to amend previous order). To summarize the dispute, due to an internal inconsistency on the date of payment in the Court's February 11, 2013 Order, the parties could not agree whether Debtor's first payment was due on February 21st or 25th. Counsel for Central National Bank demanded payment on the 21st, and when it was not received, rather than bringing the matter to the Court for clarification, or better yet, simply waiting one additional business day to see if the payment was received, contacted

again forced to intervene and set the date for the first interim payment.[11]

By virtue of 28 U.S.C. § 157(b)(2)(M), this is a core proceeding over which this Court has jurisdiction under 28 U.S.C. §§ 1334 and 157(a).

Analysis

Debtor seeks to use the rents from the Wanamaker 22 Apartments as cash collateral under 11 U.S.C. § 363(c)(2), which states that a debtor "may not use, sell, or lease cash collateral" unless "each entity that has an interest in such cash collateral consents" or "the court, after notice and a hearing, authorizes such use . . . in accordance with the provisions of this section." For rents to constitute cash collateral as that term in defined by § 363(a),[12] the rents must be "property of the estate" under 11 U.S.C. § 541(a).

Generally, courts look to state law to determine what constitutes property of the estate under § 541(a).[13] The question here is whether Congress has modified that general rule with respect to rents by enacting § 541(a)(6), which states:

Debtor's counsel on a Friday afternoon, and filed his motion to further prohibit use of rents that same day, after the close of business.

[11] Doc. 205.

[12] Section 363(a) of title 11 defines cash collateral as "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property . . ., whether existing before or after the commencement of a case under this title."

[13] *See Butner v. United States*, 440 U.S. 48, 54–55 (1979) ("Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law. Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.").

> The commencement of a case under . . . this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held: . . . Proceeds, product, offspring, rents, or profits of or from property of the estate, except such as are earnings from services performed by an individual debtor after the commencement of the case.

This Court previously held, in *In re Bryant Manor, LLC*,[14] that federal bankruptcy law—specifically § 541(a)(6)—controls the issue of whether post-petition rents of a chapter 11 debtor are property of the estate: "Congress, in enacting § 541(a)(6), defined the treatment of rents in this case, and that statute brings post-petition rents into the bankruptcy estate, effectively preempting any state law that might provide for different treatment."[15]

In *Bryant Manor*, the Court was tasked with determining whether the debtor retained an interest in postpetition rents following the appointment of a receiver in prepetition foreclosure proceedings. Just like in this case, the debtor operated an apartment complex, and its creditor held a perfected security interest in the debtor's real property and any rents or leases from the real property.[16] Regarding the assignment of rents, the Court characterized that assignment as follows:

> Although the Assignment incorporated admittedly strong language of an absolute nature, the Assignment was executed simultaneously with the mortgage documents, the mortgage indicated that the Assignment was incorporated into it, no independent consideration was given for the Assignment, the Assignment was effectively conditioned upon default (because Debtor could use the rents for any purpose until a default), the Assignment limited how the Assignee could use the rents (i.e., it could not

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[14] 422 B.R. 278 (Bankr. D. Kan. 2010).

[15] *Id.* at 289.

[16] *Id.* at 280–81.

> distribute the money to its shareholders but had to be used in connection with the subject real property), the Assignment required Assignee to account to Debtor for the rents collected/received, and the Assignment terminated upon satisfaction of the debt.[17]

The debtor Bryant Manor, although current on its loan obligations at the time, contacted the creditor to pursue a loan modification. The creditor informed debtor that if it "wanted to renegotiate the terms of the loan through a loan modification, it would have to place itself in default."[18] Unsurprisingly, the debtor then defaulted on the loan, and renewed attempts to negotiate a loan modification. The negotiations were not fruitful, and the parties were unable to agree on the terms of a modification. At that point, the creditor filed a foreclosure action and a receiver was appointed, as authorized by the parties' mortgage and security agreement. The appointed receiver thereafter took control of all incoming rents.

The debtor then filed a bankruptcy petition, seeking to use its cash collateral and to have the receiver removed. The evidence showed that the creditor was significantly under secured on the property: the debtor owed more than $3.28 million and the property was valued at $800,000.

The Court in *Bryant Manor* assessed whether federal bankruptcy law automatically brought the rents into the bankruptcy estate, regardless of the state law on the subject. The Court quoted the Supreme Court in *Butner v. United States*,[19]

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[17] *Id.* at 281.

[18] *Id.* at 282.

[19] 440 U.S. 48 (1979).

wherein the Supreme Court stated that Congress had the power to define "the mortgagee's interest in the rents and profits earned by property in a bankrupt estate."[20] At the time *Butner* was decided, there was no such federal statute (i.e.,§ 541(a)(6) had not yet been enacted). Now, "the Bankruptcy Code unambiguously defines the interests in the rents and profits earned by property in a bankrupt estate."[21]

Section 541(a)(6)'s "clear, unambiguous language"[22] dictates that "rents derived from [property of the bankruptcy estate] also constitute property of the bankruptcy estate as a matter of federal bankruptcy law."[23] In strong language, the *Bryant Manor* opinion states:

> [T]here is no need to turn to state law for resolution of this issue. Congress, in enacting § 541(a)(6), defined the treatment of rents in this case, and that statute brings post-petition rents into the bankruptcy estate, effectively preempting any state law that might provide for different treatment. Thus, even if the Court had found that Kansas law transferred complete legal title to the rents to [the creditor], § 541(a)(6) would still operate to bring those rents into the bankruptcy estate.
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> . . . [T]his statutory scheme makes sense in light of the twin goals of bankruptcy, which are (1) permitting the debtor to obtain a fresh start, and (2) ensuring that claims are paid. Congress likely recognized that the better policy is to allow the estate to use the rents to reorganize while adequately protecting the interest of the mortgagee in the rents. A contrary decision would effectively deny Chapter 11 relief to any debtor who is dependent on rents, such as hotels, apartment complexes,

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[20] *Id.* at 54.

[21] *Bryant Manor*, 422 B.R. at 288 (internal quotations omitted).

[22] *Id.*

[23] *Id.* at 288–89.

> shopping centers, office buildings, senior residence facilities, and the like.[24]

The *Bryant Manor* holding relies extensively on *In re Amaravathi Ltd. P'ship*,[25] a similar case concerning the right to rents collected by a bankruptcy estate. In *Amaravathi*, the bankruptcy court also concluded that § 541(a)(6) controlled the outcome of the case, stating: "It mandates that rents generated from property of the estate are included within the bankruptcy estate."[26] Other Circuit Court decisions squarely addressing the matter have reached the same conclusion.[27]

Based on the express language of § 541(a)(6), the postpetition rents of the Wanamaker 22 Apartments are property of the HD Gerlach Co. bankruptcy estate. Debtor is thus authorized to use those rents, as cash collateral, under § 363(c)(2).

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[24] *Id.* at 289 (internal quotations omitted).

[25] 416 B.R. 618 (Bankr. S.D. Tex. 2009).

[26] *Id.* at 638.

[27] *See In re Wheaton Oaks Office Partners Ltd. P'ship*, 27 F.3d 1234, 1240 (7th Cir. 1994) (holding that rents are cash collateral and property of the estate under § 541(a)(6)); *Vienna Park Props. v. United Postal Sav. Ass'n (In re Vienna Park Props.)*, 976 F.2d 106, 111, 114 (2d Cir. 1992) (holding that rents are property of the estate under § 541(a)(6).

The Sixth Circuit BAP identified the issue, but did not address § 541(a)(6) in *In re Buttermilk Towne Ctr., LLC*, 442 B.R. 558, 562 n.2 (6th Cir. BAP 2010) (noting that *Bryant Manor* suggests that the question of whether rent proceeds are estate property is not a question of state law, but federal law; not reaching issue).

As noted in the *Amaravathi* decision, two Third Circuit cases hold that state laws (in Pennsylvania and New Jersey) require that postpetition rents are not property of the estate, but neither case addresses the effect of § 541(a)(6) upon postpetition rents. *See Sovereign Bank v. Schwab*, 414 F.3d 450, 453 (3d Cir. 2005) (holding that assignment of rents under Pennsylvania law resulted in the bank taking title to the rents and that debtor no longer possessed an interest in the rents upon filing bankruptcy); *First Fid. Bank, N.A. v. Jason Realty, L.P. (In re Jason Realty, L.P.)*, 59 F.3d 423. 428–29 (3d Cir. 1995) (holding that absolute assignment of rents under New Jersey law requires conclusion that rents are not estate property under § 541(a)(1); subsection (a)(6) not addressed).

"Congress, in enacting § 541(a)(6), defined the treatment of rents in this case, and that statute brings post-petition rents into the bankruptcy estate, effectively preempting any state law that might provide for different treatment."[28]

Creditor Central National Bank argues to the contrary. It contends that the assignment of rents (detailed in the parties' stipulation of facts and described more fully above) was absolute—that even if Debtor paid off its debt in full today, Central National Bank would forever be entitled to keep the rents from Wanamaker 22 based on the assignment. Therefore, Central National Bank argues, there was simply no interest left for the Debtor at the time its bankruptcy petition was filed, and the rents are not property of the bankruptcy estate under § 541.

Central National Bank relies on two authorities for its position: K.S.A. § 58-2343 and an unpublished Kansas Court of Appeals case, *Leavenworth/Lansing Physicians Bldg., LLC v. Cristiano*.[29] Neither is persuasive. Section 58-2343 deals with the assignment of rents of real property, and its subsection (c) states:

> Upon default by a borrower under the terms of an assignment instrument, the lender shall be entitled to enforce the assignment instrument in accordance with its terms and applicable law, and may apply to the district court having jurisdiction for appropriate relief to gain possession and control of the rents in enforcement of the assignment instrument. Upon such application, the court shall enter such orders and take such actions as appear necessary to collect, protect, and preserve the lender's interest therein pending final disposition of an action upon the obligations secured by the assignment instrument.

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[28] *Bryant Manor*, 422 B.R. at 289.

[29] No. 102,699, 2010 WL 4977144 (Kan. Ct. App. Nov. 12, 2010) (unpublished).

In *Leavenworth/Lansing Physicians Bldg.*, the Kansas Court of Appeals addressed this statute, and stated: "Although no Kansas case has interpreted this language, it appears that the statute creates a self-help right for the lender. The statute allows lenders to contact tenants directly to collect assigned rents. . . . K.S.A. 58-2343 allows the Bank to collect rents under the assignment without judicial enforcement. . ."[30]

The Kansas Court of Appeals was then tasked with determining whether the assignor (also the lessor in that case) still maintained a cause of action to recover the rents from a lessee when the assignee (the bank) had already collected the rents via self help after the assignor/lessor defaulted.[31] The Court of Appeals noted the general rule in Kansas that "an assignment passes all the assignor's title and interest under a contract to the assignee and divests the assignor of all right of control over the subject matter of the assignment."[32] The Court of Appeals then concluded that the "extremely broad" language of the assignment in that case divested the assignor "of all right to control over the subject matter of the assignment."[33] As a result, the Court of Appeals concluded that the assignor did not retain standing to recover rents under the lease from the lessee.[34]

Contrary to the assertion in *Leavenworth/Lansing Physicians Bldg.* and the

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[30] *Id.* at *9–10.

[31] *Id.* at *10.

[32] *Id.*

[33] *Id.*

[34] *Id.* at *11.

argument made by Central National Bank, although K.S.A. § 58-2343 was enacted in 1991, subsequent cases have confirmed that Kansas is a lien theory state, and requires judicial foreclosure to exercise rights under a mortgage. For example, in *Premier Bank v. J.D. Homes of Olathe*,[35] a 2002 Kansas Court of Appeals case, the court reiterated the Kansas position on mortgage law:

> Kansas is a lien theory state, not a title theory state. In a title theory jurisdiction, the mortgage is viewed as a form of title to property. . . . In lien theory state, a mortgagee is not entitled to immediate possession of the property upon default because the mortgage is merely a lien and not a form of title. . . .
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> Under Kansas law, a mortgagee does not acquire an interest in the property, either before or after the promise to pay is broken, but acquires only a lien securing the indebtedness described in the instrument.[36]

Also, in the 1993 Kansas Court of Appeals case *Hoelting Enterprises v. Trailridge Investors, L.P.*,[37] the court squarely addressed an assignment of rents under the lien theory, without reference to K.S.A. § 58-2343. The published *Hoelting Enterprises* opinion expressly rejected the position seemingly stated in the unpublished *Leavenworth/Lansing Physicians Bldg.* decision:

> Under Kansas law, therefore, a purely executory agreement alone is not effective to vest in a mortgagee the right to rents and profits. The right to rents and profits may vest in a mortgagee, however, if (1) the mortgagor defaults and the court appoints a receiver, or (2) the mortgage assigns the rents and the mortgagee reduces the rents to his possession by proper legal action. Proper legal action that may vest in a mortgagee the right to rents and profits pursuant to such an assignment includes a

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[35] 50 P.3d 517 (Kan. Ct. App. 2002).

[36] *Id.* at 519.

[37] 844 P.2d 745 (Kan. Ct. App. 1993).

> court's appointment of a receiver, and a mortgagor's voluntary consent to the mortgagee obtaining possession of the rents.[38]

The *Hoelting Enterprises* opinion mentions K.S.A. § 58-2343, but only as it relates to *perfection* of the security interest in the rents, not with regard to vesting of the right to those rents in the mortgagee.[39]

The statute (K.S.A. § 58-2343) itself implies that judicial involvement is still necessary:[40] although the statute provides that the lender "shall be entitled to enforce the assignment in accordance with [the assignment's] terms," the statute also seems to imply that judicial involvement is necessary by stating that "the court shall" enter orders and take actions necessary to "collect, protect, and preserve the rents." On the other hand, the statute does use the word "may" when referring to judicial enforcement, implying that judicial involvement is not required.

Further complicating matters, however, is that the statute seems to require court action for "final disposition." Either interpretation of § 58-2343(c)—that judicial involvement is or is not necessary—is far from clear, making the statute ambiguous.[41]

"If a statute is ambiguous, a court may seek guidance from [legislative] intent,

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[38] *Id.* at 749–50 (internal citations omitted).

[39] *Id.* at 751–52.

[40] *See Office of Thrift Supervision v. Overland Park Fin. Corp. (In re Overland Park Fin. Corp.)*, 236 F.3d 1246, 1251 (10th Cir. 2001) ("In any case of statutory construction, the starting point of our analysis must begin with the language of the statute itself.").

[41] *See Allen v. Geneva Steel Co. (In re Geneva Steele Co.)*, 281 F.3d 1173, 1178 (10th Cir. 2002) (stating that "[a]n ambiguity exists when a statute is capable of being understood by reasonably well-informed persons in two or more different senses" (internal quotations omitted)).

a task aided by reviewing the legislative history."[42] The legislative history of K.S.A. § 58-2343 sheds only minimal light on the Kansas legislature's intent. The minutes of the Senate Committee where the bill (that would later become K.S.A. § 58-2343) was introduced indicate that the bill was intended as only a clarification of the law regarding how lenders perfected their interest in an assignment of rents, and not a change in the law regarding an enforcement of an assignment.[43] Other portions of those same minutes, however, state that the committee intended to study whether "the language in the bill needs to be changed so as not to eliminate self-help,"[44] which would have been a change to how an assignment of rents was enforced by a lender. It does seem clear, however, that the issue K.S.A. § 58-2343 sought to address (at least initially) was the perfection of a rent assignment, not an assignment's enforcement.

Regardless, apparently unlike the situation in the *Leavenworth/Lansing Physicians Bldg* case (although not extensively addressed therein), the assignment of rents that was executed between Central National Bank and Debtor and that was later pursued by Central National Bank was *not* absolute in this case, despite Central National Bank's argument to the contrary. Here, the parties' assignment requires that rents be applied to the balance of the note, stating that all rents shall be paid to Central National Bank and applied to the principal and interest owed by Debtor. The

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[42] *Id.*

[43] S. Comm. on Financial Institutions & Insurance, at 1 (Kan. Feb. 14, 1991) (minutes of committee meeting where bill introduced); Attach. 1 (proposal for legislation).

[44] S. Comm. on Financial Institutions & Insurance, at 2 (Kan. Feb. 14, 1991).

parties' Assignment implies that the rights within the Assignment ride along with the parties' Mortgage, and the Assignment was conditioned upon default of that Mortgage. Even the agreed order entered between the parties in the state court foreclosure litigation stated that rents collected by Central National Bank were to be applied to the balance of the note. Under the long-standing case law in Kansas discussed above, the parties' "purely executory agreement"[45] was not effective to vest in Central National Bank the right to the rents of the Wanamaker 22 Apartments.

Neither K.S.A. § 58-2343 nor the holding in the unpublished decision in *Leavenworth/Lansing Physicians Bldg.* changes the outcome required by this Court's prior holding in *Bryant Manor*. There is no published Kansas decision stating that Kansas has changed it's long-standing position as a lien theory state, and the text of the statute is not clear enough to require a holding that the facts of this case show an absolute assignment of the rents from the Wanamaker 22 Apartments that would defeat § 541(a)(6). To the contrary, the "clear, unambiguous language"[46] of § 541(a)(6) dictates that "rents derived from [property of the bankruptcy estate] also constitute property of the bankruptcy estate as a matter of federal bankruptcy law."[47]

Conclusion

The Court finds that 11 U.S.C. § 541(a)(6) controls the outcome of this case: the "proceeds, product, offspring, rents, or profits of or from property of the estate" are

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[45] *Hoelting Enterprises*, 844 P.2d at 749.

[46] *Bryant Manor*, 422 B.R. at 288.

[47] *Id.* at 288–89.

property of the bankruptcy estate. The Court grants the second motion to use cash collateral[48] of Debtor HD Gerlach Co.,[49] and the Debtor's offer, codified in the Court's orders of January 11, 2013 and January 19, 2013 (as modified), to pay interest and provide certain reports to Central National Bank, remains in effect.

It is so ordered.

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[48] Doc. 107.

[49] The April 10, 2013 hearing previously scheduled to announce this decision is cancelled.