

IN THE UNITED STATES DISTRICT COURT FOR THE
DISTRICT OF NEBRASKA

IN THE MATTER OF:

RICHARD and EUNICE MAHLOCH,

Debtors and Debtors-
in-Possession.

IN THE MATTER OF:

DENNIS MAHLOCH,

Debtor and Debtor-
in-Possession.

CV. 84-0-349

BK. 82-2072

CV. 84-0-350

BK. 82-2073

MEMORANDUM OPINION

FILED
DISTRICT OF NEBRASKA

JUN 10 1985

William L. Olson, Clerk

Dep.

These matters are before the Court on appeals from findings and orders of the bankruptcy court entered on May 25, 1984. The appellant in both appeals, Saline State Bank (hereinafter Bank), appeals the decisions of the bankruptcy court denying Bank's applications to sequester rents and profits. This Court, after carefully reviewing the consolidated record on appeal and the briefs filed by the respective parties, is of the view that the May 25, 1984, orders of the bankruptcy court should be reversed and these matters be remanded for proceedings consistent with this opinion.

The facts are these. On November 30, 1982, debtors filed their petitions under Chapter 11 of the United States Bankruptcy Code. Bank subsequently filed its proofs of claims in excess of one million dollars in each of the estates herein, such claims secured by real estate mortgages, security interests in crops, and assignment of land contracts and a portion of debtor's claims in two other

bankruptcy estates. The mortgages and land contracts contain a provision for assignment of rents and profits to the Bank upon default by the mortgagee. Such provision states:

Provided further, that upon such default the Mortgagee, or a receiver appointed by the court, may at his option and without regard to the adequacy of the security, enter upon and take possession of the Property and collect the rents, issues and profits therefrom and apply them first to the cost of collection and operation of the Property and then upon the indebtedness secured by the Mortgage; said rents, issues and profits being hereby assigned to the Mortgagee as further security for the payment of the indebtedness secured hereby.

It is undisputed that debtors were in default on the applicable promissory notes and loan agreements when they filed their bankruptcy petitions. Nevertheless, as debtors in possession, they continued to operate their farming business in 1983, obtaining rental income and Payment-in-Kind (PIK) program benefits from the encumbered property. On September 28, 1983, Bank filed its applications to sequester rents and profits, seeking to protect its asserted interest in rent, crop-proceeds and PIK benefits. Following a hearing and oral argument on the applications, the Honorable David L. Crawford, Bankruptcy Judge, denied such applications. In his memorandum and order, Judge Crawford essentially held that the Bank could not obtain sequestration in the bankruptcy court proceedings since it had not initiated foreclosure actions and sought the appointment of a receiver prior to debtors' filing of their bankruptcy petitions. Thereafter, timely appeals were filed by the Bank and are now before this Court.

Before this Court addresses the merits of the appeal, it is prudent to state the general standard of review that guides the Court in matters such as this. Although on appeal, the bankruptcy judge's findings of fact are generally entitled to stand unless clearly erroneous, where there are presented mixed questions of law and fact, the clearly erroneous rule is not applicable, *In re American Beef Packers, Inc.*, 457 F.Supp. 313, 314 (D.Neb. 1978), and the bankruptcy judge's decision cannot be approved without this Court's independent determination of the law. *In re Werth*, 443 F.Supp. 738, 739 (D.Kansas 1977), citing *Stafos v. Jarvis*, 477 F.2d 369, 372 (10th Cir.), cert. denied, 414 U.S. 944 (1973).

Section 552(b) of the Bankruptcy Code provides, as relevant herein, that under certain conditions rents and profits acquired post-petition are to be included within the security interest created by a pre-petition security agreement:

if the debtor and a 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, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

In *Butner v. United States*, 440 U.S. 48 (1979), the Supreme Court clearly established that state law governs the rights to rents and profits realized from secured property. The Court held:

. . . [O]ur decision avoids the . . .

inequity of depriving a mortgagee of his state-law security interest when bankruptcy intervenes. For while it is argued that bankruptcy may impair or delay the mortgagee's exercise of his right to foreclosure, and thus his acquisition of a security interest in rents according to the law of many States, a bankruptcy judge familiar with local practice should be able to avoid this potential loss by sequestering rents or authorizing immediate state-law foreclosures. Even though a federal judge may temporarily delay entry of such an order, the loss of rents to the mortgagee normally should be no greater than if he had been proceeding in a state court: for if there is a reason that persuades a federal judge to delay, presumably the same reason would also persuade a state judge to withhold foreclosure temporarily. The essential point is that in a properly administered scheme in which the basic federal rule is that state law governs, the primary reason why any holder of a mortgage may fail to collect rent immediately after default must stem from state law. The federal bankruptcy court should take whatever steps are necessary to ensure the mortgagee is afforded in federal bankruptcy court the same protection he would have under state law if no bankruptcy has ensued.

Id. at 56-57. Thus, the bankruptcy court, and this Court on review, must look to the law of the State of Nebraska.

Under such law, assignment of rents and profits clauses are valid and enforceable. *Central Nebraska Savings Bank v. First Cadco Corp.*, 186 Neb. 112, 181 N.W.2d 261 (1970); *Pennsylvania Mutual Life Ins. Co. v. Katz*, 139 Neb. 501, 297 N.W. 899 (1941). Although the relevant clauses herein expressly provide for the right of the mortgagee to take possession of the underlying property and collect the rents and profits on default, Nebraska law also recognizes an "equitable lien" theory upon default:

[O]n a condition broken by which the mortgagee is authorized to commence foreclosure proceedings, if the property be inadequate security [the mortgage] has thence forward an equitable lien upon the rents and profits, or so

much thereof as may be necessary to the security of the mortgage debt which he may enforce by proper proceedings.

Outside of the bankruptcy context, enforcement of such a lien is accomplished by the commencement of a foreclosure proceeding and request that a receiver be appointed to collect the rents and profits. *Prudential Ins. Co. v. Farm Inv. Co.*, 123 Neb. 578, 243 N.W. 832 (1932); *Huston v. Canfield*, 57 Neb. 345, 77 N.W. 763 (1899). The mortgagee must be able to demonstrate that the value of the underlying real estate is insufficient to discharge the debt. *Prudential Ins. Co. v. Farm Inv. Co.*, *supra*, 243 N.W. at 846.

As this Court recently noted, the filing of a bankruptcy petition thwarts the creditor's ability to freely pursue the above procedure. However, § 552(b) of the Bankruptcy Code and the Supreme Court's holding in *Butner* mandate that a procedure be utilized within the bankruptcy context to protect the pre-bankruptcy substantive rights of the creditor.

[I]f a trustee or mortgagee is able to establish the property is inadequate to secure the debt, then the Bankruptcy Court should devise a procedure to likewise protect the creditor's interest in the [rents and profits] forwarded from that point in time. Since bankruptcy stays any foreclosure proceedings . . . separation of the [rents and profits] and their treatment as cash collateral would ensure the creditor protection similar to the protection he would have under state law had no bankruptcy ensued. The Bankruptcy Court would be exercising its equitable powers to protect substantive rights which do exist under state law.