

# Circuit Split Developing over Modification of Mortgages on Mixed-Use Properties

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*The U.S. Bankruptcy Court for the Eastern District of New York recently evaluated three approaches to treatment of mixed-use properties under Section 1322: the U.S. Courts of Appeals for the First and Third Circuit's bright-line approach interpreting the plain language in Section 1322, a differing bright-line approach interpreting the same language, and a case-by-case approach based on legislative intent. After its analysis of all approaches, the court adopted a bright-line approach opposite that of the First and Third Circuits, and barred modification of a mortgage secured by the principal residence even if it generates income from other uses. The authors of this article discuss the decision and its implications.*

A bankruptcy court in New York recently became the latest to weigh in on the developing circuit court split regarding whether modification of mortgages should be permitted under 11 U.S.C. § 1322(b)(2) when the personal residence securing the mortgage is also used for commercial purposes.<sup>1</sup> The U.S. Courts of Appeals for the First and Third Circuits have long since adopted the same bright-line approach to application of that section, however, they have refused to apply Section 1322(b)(2)'s anti-modification provision to properties with any mixed use.<sup>2</sup> However, the New York court is one of an increasing number of lower courts to resist this approach.<sup>3</sup> The emerging circuit split, which has created three variations of Section 1322(b)(2) interpretation, creates uncertainties for lenders concerning treatment of their secured claims; a court's chosen

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<sup>1</sup> *In re Addams*, 564 B.R. 458 (Bankr. E.D.N.Y. 2017).

<sup>2</sup> *Lomas Mortg., Inc. v. Louis*, 82 F.3d 1 (1st Cir. 1996); *Scarborough v. Chase Manhattan Mortg. Corp. (In re Scarborough)*, 461 F.3d 406 (3d Cir. 2006).

<sup>3</sup> See, e.g., *In re Brooks*, 550 B.R. 19, 25 (Bankr. W.D.N.Y. 2016); *In re Zaldivar*, 441 B.R. 389, 390 (Bankr. S.D.Fla. 2011); *In re Macaluso*, 254 B.R. 799 (Bankr. W.D.N.Y. 2000).

interpretation of Section 1322 alone may determine whether the lender's claim will remain fully secured as claimed or be bifurcated and stripped down.

In its opinion in *In re Addams*,<sup>4</sup> the U.S. Bankruptcy Court for the Eastern District of New York evaluated all three approaches to treatment of mixed-use properties under Section 1322: the First and Third Circuit's bright-line approach interpreting the plain language in Section 1322, a differing bright-line approach interpreting the same language, and a case-by-case approach based on legislative intent.<sup>5</sup> After its analysis of all approaches, the court adopted a bright-line approach opposite that of the First and Third Circuits, and barred modification of a mortgage secured by the principal residence even if it generates income from other uses.<sup>6</sup>

### CASE BACKGROUND

In *Addams*, the Chapter 13 debtor resided on a property that held a single two-family structure; the debtor lived in one with her children as their principal residence, and the debtor rented out the second half of the structure. In drafting her Chapter 13 plan, debtor attempted to bifurcate the mortgage on the property. The creditor-mortgagor for the property argued that the debtor could not modify the mortgage pursuant to Section 1322(b)(2) of the Bankruptcy Code, which permits a Chapter 13 debtor to modify a secured claim "other than a claim secured only by a security interest in real property that is the debtor's principal residence."<sup>7</sup> The creditor claimed that the real property securing the mortgage constituted the debtor's principal residence, and thus the anti-modification provision in Section 1322(b)(2) should apply.<sup>8</sup> In response, the debtor argued that the property securing the mortgage was a mixed-use property because she rented out half of the structure on the property; this mixed use, the debtor argued, meant that the property was no longer a "principal residence" for purposes of Section 1322(b)(2), and modification of the mortgage on the property should be permitted.<sup>9</sup>

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<sup>4</sup> *Id.*

<sup>5</sup> *See Addams*, 564 B.R. at 464–66.

<sup>6</sup> *Id.* at 466.

<sup>7</sup> 11 U.S.C. § 1322(b)(2).

<sup>8</sup> *Addams*, 564 B.R. at 459.

<sup>9</sup> *Id.*

## ANALYSIS OF POSSIBLE APPROACHES

The court examined the three different approaches to application of Section 1322 in order to determine whether the debtor should be permitted to bifurcate the creditor's claim. The first bright-line approach focuses on the plain language of Section 1322(b)(2), which prohibits modification of claims secured by "real property that is the debtor's principal residence."<sup>10</sup> Courts adopting this approach, including the First and Third Circuits, focus on the word "is" in the statute to determine that the statute equates the terms "real property" and "principal residence."<sup>11</sup> Thus, such courts conclude that the anti-modification provision applies only when the real property securing the mortgage is only the debtor's principal residence, without any other uses.<sup>12</sup>

Under this approach, courts have rendered 1322(b)(2) inapplicable and permitted modification of mortgages when the property at issue was used as income-generating rental property, or when the property was used for both residential and commercial purposes, such as a residence above an automotive business.<sup>13</sup> Critics of the approach have pointed out that it permits modification of a mortgage on a debtor's principal residence the moment a debtor decides to rent out a garage apartment or extra room.<sup>14</sup>

The second bright-line approach to applying Section 1322(b)(2) also focuses on the statute's plain language, but bases its interpretation on the placement of the word "only" within the statute. The statute prohibits modification of claims "secured *only* by a security interest in real property,"<sup>15</sup> and courts using this approach explain that "only" modifies the security of the transaction, not the nature of the real property at issue.<sup>16</sup> The courts explain that "the statute does not limit its application to property that is used *only* as a principal residence, but refers generally to any parcel of real property that the debtor uses for that purpose."<sup>17</sup> Courts using the second bright-line method further conclude that

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<sup>10</sup> 11 U.S.C. § 1322(b)(2).

<sup>11</sup> *Scarborough*, 461 F.3d at 411–14.

<sup>12</sup> *Id.*; see also *Lomas*, 82 F.3d at 7.

<sup>13</sup> *In re Galaske*, No. 11-10891 (Bankr. D.Vt. Nov. 16, 2011).

<sup>14</sup> See *Zaldivar*, 441 B.R. at 390; *Laycock*, 497 B.R. at 400.

<sup>15</sup> 11 U.S.C. § 1322(b)(2) (emphasis added).

<sup>16</sup> *Id.* at 464.

<sup>17</sup> *Id.*, citing *Macaluso*, 254 B.R. at 800 (emphasis in original).

rental income in particular constitutes an “additional aspect of a creditor’s security interest in real property, not an additional, distinct piece of collateral.”<sup>18</sup>

Thus, the second approach turns on whether the real property includes the debtor’s principal residence.<sup>19</sup> So long as the debtor principally resides at the real property in question, modification is prohibited under Section 1322(b)(2)—even if the real property is subject to mixed use.<sup>20</sup> Courts using this approach have prohibited modification of properties such as (i) real property containing a tailor shop and two residential apartments, one of which the debtor lived in<sup>21</sup> and (ii) a multifamily home including the debtor’s principal residence and two apartment units.<sup>22</sup> However, courts critical of the approach have expressed concern that it may go further than these examples, because the approach “places too much emphasis on whether the real property includes debtor’s principal residence without regard to the other uses, which might in fact be the predominant purpose of the property.”<sup>23</sup>

The final approach to application of Section 1322(b)(2) is a case-by-case approach that considers the totality of the circumstances surrounding the real property.<sup>24</sup> The question turns on what the parties intended: “[w]as home-ownership the predominant intention (and rental income simply a means to that end) or was investment income or the operation of a business the predominant purpose of the transaction?”<sup>25</sup> If the parties intended the scope of a creditor’s lien to encompass a commercial loan transaction, modification should be permitted under the case-by-case approach. However, if the parties intended the creditor to provide the borrower with a residence, regardless of supplemental rental income, Section 1322(b)(2) applies to preclude modification.<sup>26</sup> This approach has also been met with criticism for “introduc[ing] uncertainty and unpredictability to residential mortgage transactions, because it requires

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<sup>18</sup> *In re Mayer-Myers*, 345 B.R. 127, 130–31 (Bankr. D.Vt. 2006).

<sup>19</sup> *See, e.g., Macaluso*, 254 B.R. at 800; *Brooks*, 550 B.R. at 25.

<sup>20</sup> *See id.*

<sup>21</sup> *Macaluso*, 254 B.R. at 800.

<sup>22</sup> *Brooks*, 550 B.R. at 26.

<sup>23</sup> *Addams*, 564 B.R. at 464; *see also Zaldivar*, 441 B.R. at 390; *Laycock*, 497 B.R. 400.

<sup>24</sup> *See, e.g., Brunson v. Wendover Funding, Inc. (In re Brunson)*, 201 B.R. 351 (Bankr. W.D.N.Y. 1996); *Litton Loan Serv., LP v. Beamon*, 298 B.R. 508, 512 (N.D.N.Y. 2003); *Zaldivar*, 441 B.R. at 390.

<sup>25</sup> *Addams*, 564 B.R. at 465.

<sup>26</sup> *Id.*

courts to engage in subjective, hindsight analysis as to the intent of the parties.”<sup>27</sup>

### THE *ADDAMS* COURT’S DECISION

After outlining and analyzing the strengths of all three possible approaches, the court rejected the First and Third Circuits’ approach, instead adopting the bright-line “so long as it is a principal residence” approach.<sup>28</sup> In support of its decision, the court relied on a daisy-chain of statutory definitions. First, Section 1322(b)(2) permits modification of a secured claim “other than a claim secured only by a security interest in real property that is the debtor’s principal residence.”<sup>29</sup> Second, “principal residence” is defined within the Bankruptcy Code as a “residential structure if used as the principal residence by the debtor, including incidental property.”<sup>30</sup> Finally, “incidental property” includes “rents” and “property commonly conveyed with a principal residence in the area where the real property is located.”<sup>31</sup>

Based on these definitions, the court concluded that “Congress defined the debtor’s principal residence to include rents derived from the real property, and, as such, a security interest in rents is part of the security interest in the principal residence.”<sup>32</sup> Thus, the court reasoned, a mortgage secured by real property that is the debtor’s principal residence cannot be modified under Section 1322(b)(2), regardless of whether the property generates rental income. With its decision, the *Addams* court joined a line of courts rejecting the First and Third Circuits’ approach and provided additional reasoning in support of the alternate bright-line approach.

### IMPLICATIONS

The emergence of a circuit split will no doubt introduce confusion within the residential mortgage realm. Lenders in jurisdictions using the bright-line approach allowing modification of property with any mixed use might expect increased certainty, but even lower courts within bright-line jurisdictions such as the Third Circuit have chosen to distinguish their cases from such authority

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<sup>27</sup> *Scarborough*, 461 F.3d at 414.

<sup>28</sup> *Addams*, 564 B.R. at 466.

<sup>29</sup> 11 U.S.C. § 1322(b)(2).

<sup>30</sup> *Id.* at § 101(13A)(A).

<sup>31</sup> *Id.* at § 101(27B).

<sup>32</sup> *Addams*, 564 B.R. at 466.

in order to achieve the perceived equitable result.<sup>33</sup> However, lenders can find some comfort in courts' increasing resistance to the First and Third Circuits' refusal to apply the anti-modification provision of Section 1322 to mixed-use properties. After *Addams's* detailed analysis of each approach to application of Section 1322, its resulting rejection of the First and Third Circuits' approach and its additional statutory construction supporting a new bright-line approach, the number of courts embracing the "so long as it is a principal residence" bright-line approach will likely only continue to increase.

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<sup>33</sup> See, e.g., *In re Hoffman*, No. 15-10156 (D.N.J. May 23, 2016).