IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

In re:	:	
	:	
FRANCES SCARBOROUGH,	:	
Debtor.	:	Misc. No. 03-228

MEMORANDUM AND ORDER

J. M. KELLY, J. **OCTOBER , 2004**

Presently before the Court is a bankruptcy appeal in the above captioned case. Appellant-debtor Frances Scarborough ("Scarborough") has appealed the United States Bankruptcy Court for the Eastern District of Pennsylvania's ("Bankruptcy Court") judgment barring her from bifurcating the secured claim of appellee Chase Manhattan Mortgage Corporation ("Chase Manhattan") pursuant to the anti-modification provision of the Bankruptcy Code, 11 U.S.C. § 1322(b)(2). See Scarborough v. Chase Manhattan Mortgage Corp. (In re Scarborough), Adv. No. 02-858, slip op. at 2 n.3 (Bankr. E.D. Pa. Oct. 14, 2003). This Court has jurisdiction over the appeal pursuant to 28 U.S.C. § 158(a). For the reasons set forth below, the judgment of the Bankruptcy Court is **AFFIRMED**.

I. BACKGROUND

A. Factual History

In its October 14, 2003 Memorandum and Order,[1] the

[1] See In re Scarborough, Adv. No. 02-858, at 2-3 (outlining the relevant facts).

Bankruptcy Court set forth the following relevant facts:

1. On May 10, 1988, Scarborough signed a mortgage ("Mortgage") in favor of Meritor Savings Bank granting a mortgage lien against Scarborough's property located at 5116 N. Warnock Street, Philadelphia, PA 19141 ("Property") to secure a note to Meritor Savings Bank, executed on the same date in the amount of $30,400.00.[2]

2. The form of the Mortgage is a "Pennsylvania - Single Family - FNMA/FHLMC Uniform Instrument." The Mortgage contains the following language:

> TOGETHER WITH all the improvements now or hereafter erected on the property, and all easements, rights, appurtenances, rents, royalties, mineral, oil and gas rights and profits, water rights and stock and all fixtures now or hereafter a part of the property.

3. Also on May 10, 1988, Scarborough signed a "2-4 Family Rider (Assignment of Rents)" ("Family Rider") to "amend and supplement the Mortgage" and further secure her note to Meritor Savings Bank.[3]

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[2] Although no evidence of an assignment to Chase Manhattan was submitted at trial, the parties agree that Chase Manhattan is the current holder of the Mortgage. See In re Scarborough, at 2, n.3.

[3] The Family Rider provides:

> Borrower unconditionally assigns and transfers to Lender all rents and revenues of the Property. Borrower authorizes Lender or Lender's agents to collect the rents to

4. The Property is a two-story semi-detached residence that was converted to a multi-unit dwelling with one apartment on the first floor and one apartment on the second floor. The Property was converted prior to Scarborough's purchase.

5. Scarborough lives on the first floor and rents the second floor apartment to Darrell Mills, who is not related to Scarborough, pursuant to a lease agreement dated February 8, 2000.

6. Scarborough filed her Chapter 13 petition on October 31, 2001. (Appellant Br. at 9.)

7. At trial on November 21, 2002, Scarborough testified that

> Lender or Lender's agents. However, prior to Lender's notice to Borrower of Borrower's breach of any covenant or agreement in the Security Instrument, Borrower shall collect and receive all rents and revenues of the Property as trustee for the benefit of Lender and Borrower. This assignment of rents constitutes an absolute assignment and not an assignment of additional security only.

In re Scarborough, at 4 (citing Ex. D-1). The Family Rider also contains an "Assignment of Leases" provision that provides:

> Upon Lender's request, Borrower shall assign to Lender all leases of the Property and all security deposits made in connection with the leases of the Property. Upon assignment, Lender shall have the right to modify, extend, or terminate the existing leases and to execute new leases, in Lender's sole discretion.

Id. at 4-5 (citing Ex. D-1).

she purchased the Property with the intent of living in one unit and renting the other, and with a goal of eventually acquiring other investment properties. She further testified that she informed the bank she was buying the property, in part, as an investment.

8. At the time of the purchase, she was employed full time by the City of Philadelphia as an Income Maintenance Worker. She continued that job after purchasing the Property, however, at the time of the trial, Scarborough was unemployed. Although she attends classes from time to time, she was not taking any at the time of trial.

9. Scarborough testified that the value of the Property was $13,000.00 Chase Manhattan submitted the City of Philadelphia's Board of Revision of Taxes Property Record which listed the value of the Property as $26,500. Scarborough has appealed the Board of Revision of Taxes' valuation, but her appeal had not been decided as of the date of trial.[4]

B. Procedural History

As stated, Scarborough filed a Chapter 13 petition on March 2, 2001. On July 27, 2002, Scarborough filed a complaint seeking

[4] Scarborough's Appellant Reply Brief claims that the Property is listed as $8,480.00 by the Board of Revision of Taxes of the City of Philadelphia. (Appellant's Reply Br. at 6.)

to bifurcate the claim of Chase Manhattan into a secured claim and an unsecured claim pursuant to 11 U.S.C. § 506(a) and to determine the correct amount of the mortgage arrearage. On September 24, 2002, Scarborough filed an amended complaint to revise the alleged amounts of the secured and unsecured portions of Chase Manhattan's claim. Specifically, Scarborough sought to bifurcate Chase Manhattan's lien on her residence to reflect the current market value of the property with the remainder of the debt becoming unsecured. The Bankruptcy Court denied this appeal and concluded that Scarborough was barred from bifurcating the secured claim of Chase Manhattan pursuant to 11 U.S.C. § 1322(b)(2)'s "anti-modification" provision. Scarborough filed the instant appeal.

II. DISCUSSION

A. Scope of Review on Appeal

In cases originating in the bankruptcy court, the district court occupies the first level of appellate review. 28 U.S.C. § 158(a). The district court must apply a clearly erroneous standard of review to findings of fact and a de novo standard of review to questions of law. See In re Berkery, 192 B.R. 835, 837 (E.D. Pa. 1996), aff'd, 111 F.3d 125 (3d Cir. 1997).

Scarborough's appeal challenges the Bankruptcy Court's legal conclusion that Chase Manhattan's claim is subject to the

protections of the anti-modification clause of § 1322(b)(2). Scarborough does not challenge the facts that led the Bankruptcy Court to its conclusion. As the issues before the Court relate to statutory interpretation and conclusions of law, the scope of this Court's review is plenary.

B. Modification of a Secured Claim

This dispute involves the interplay of the following two Bankruptcy Code provisions: 11 U.S.C. § 506(a) and 11 U.S.C. § 1322(b)(2). Bankruptcy Code § 506(a) defines allowed secured and allowed unsecured claims in bankruptcy. See 11 U.S.C. § 506(a).[5] Section 506(a) allows debtors to bifurcate a creditor's secured claim to the value of the underlying collateral.[6] See 11 U.S.C. § 506(a). The remainder of the creditor's claim then becomes

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[5] Section 506(a) states:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to set off is less than the amount of such allowed claim.

11 U.S.C. § 506(a).

[6] Claim bifurcation has also been referred to by other courts as "strip down" or "cram down" of secured claims.

unsecured. Id. As summarized by the United States Supreme Court: "[s]ubsection (a) of 506 provides that a claim is secured only to the extent of the value of the property on which the lien is affixed; the remainder of that claim is unsecured." United States v. Ron Pair Enterprises, Inc., 489 U.S. 235 (1989).

Tension arises between §§ 506(a) and 1322(b)(2) in a Chapter 13 bankruptcy filing. Section 1322 governs Chapter 13 repayment plans.[7] See 11 U.S.C. § 1322. Section 1322(b)(2) contains a specific provision concerning modification of the rights of holders of secured and unsecured claims, here Chase Manhattan. 11 U.S.C. § 1322(b)(2).[8] A debtor's ability to bifurcate a secured claim pursuant to § 506(a) is limited by § 1322(b)(2)'s demand that a Chapter 13 plan may "modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence. . . ." See Id.; see also Nobelman v. American Sav.

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[7] In general, § 1322 permits eligible individuals with regular income to repay their debts through a repayment plan approved by a bankruptcy court. See 11 U.S.C. § 1322.

[8] Section 1322(b)(2) provides that a plan may:

> [M]odify the rights of holders of secured claims other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims.

11 U.S.C. § 1322(b)(2).

Bank, 508 U.S. 324, 332 (1993). In short, § 1322(b)(2) specifically protects the rights of creditors from having a Chapter 13 debtor use § 506(a) to bifurcate a mortgage on the debtor's principal residence between the mortgaged residence's fair market value and the remaining unsecured portion of the claim. Id.

Scarborough appeals the Bankruptcy Court's holding that § 1322(b)(2)'s anti-modification provision protects Chase Manhattan's claim from bifurcation on two grounds. First, Scarborough argues that § 1322(b)(2) does not apply because the Mortgage and the attached Family Rider grant Chase Manhattan additional collateral in the Property's rents. Second, Scarborough argues that the protection of § 1322(b)(2) does not apply to a secured claim on a multi-unit property in which one unit is the debtor's principal residence and the other is an income producing unit.

1. Chase Manhattan's Collateral is not Personal Property

Section 1322(b)(2)'s anti-modification clause only applies if the underlying collateral is limited to the principal residence. See In re Hammond, 27 F.3d 52, 57 (3d Cir. 1994) (finding that the word "only" in § 1322(b)(2) modifies "principal residence," and § 1322(b)(2)'s protection does not apply to "appliances, machinery, furniture, and equipment"). In other

words, additional security or collateral that is set forth in a residential mortgage is sufficient to over come the anti-modification provision of § 1322(b)(2). Id.

Scarborough argues that language in the Mortgage grants a security interest in personal property, as opposed to the principal residence, thus removing it from the protection of § 1322(b)(2)'s anti-modification clause.[9] Scarborough argues that the "rents" are personal property and by including "rents" in the Mortgage, Chase Manhattan has created a right to additional collateral thereby removing the protection it otherwise could claim under § 1322(b)(2). We must, therefore, consider whether the additional interest of "rents" provided in the Mortgage should be considered realty or personalty. If the interest is considered part of Scarborough's realty then the anti-modification provision of § 1322(b)(2) would apply. However, if the interest is considered a security that is in addition to Scarborough's principal residence, then it is a

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[9] The language of the Mortgage that Scarborough points to as creating personal property states:

> TOGETHER WITH all the improvements now or hereafter erected on the property, and all easements, rights, appurtenances, rents, royalties, mineral, oil and gas rights and profits, water rights and stock and all fixtures now or hereafter a part of the property.

In re Scarborough, at 4 (citing Ex. D-1).

personalty and Scarborough is entitled to use § 506(a) to bifurcate the claim.

The Bankruptcy Court correctly concluded that under Pennsylvania law, "rents" are real property. See 21 PA. CONS. STAT. ANN. § 3 (West 2001); In re Scarborough, at 5; see also Steslow v. Citicorp Mortgage, Inc. (In re Steslow), 225 B.R. 883, 884-85 (Bankr. E.D. Pa. 1998) (holding that rents alone are an interest in real estate, but that rents placed in an escrow account pursuant to a mortgage are additional collateral for § 1322(b)(2) purposes). Numerous other courts in the Eastern District of Pennsylvania have also stated that, as real property, a security interest in rents does not grant an interest in personal property and is not additional collateral for § 1322(b)(2) purposes. See In re Abruzzo, 245 B.R. 201, 209-10 (Bankr. E.D. Pa. 1999) vacated and remanded on other grounds 2000 U.S. Dist. LEXIS 4936 at *2 (E.D. Pa. Apr. 7, 2000) (citing Pennsylvania law holding that language in a mortgage that grants a security interest in items such as rents does not create a security interest in personal property); Rodriguez v. Mellon Bank, N.A. (In re Rodriguez), 218 B.R. 764, 776 (Bankr. E.D. Pa. 1998) (explaining "[t]he Court will not exclude a mortgage from protection [of § 1322(b)(2)] because it separtely identifies as an item of security something that is part of the real estate under state law, such as rents"); Wilkinson v. Fleet Mortgage

Corp. (In re Wilkinson), 189 B.R. 327, 329-30 (Bankr. E.D. Pa. 1995) (finding that "for purposes of § 1322(b)(2), the security interest in the rents is not security other than in real property that is Debtors' principal residence"). Therefore, the Mortgage's inclusion of an interest in "rents" is not additional collateral, and Chase Manhattan's secured claim is protected pursuant to § 1322(b)(2)'s anti-modification clause.[10]

2. The Property's Multi-Unit Status Does Not Require Bifurcation

Scarborough's second argument is that the protection of § 1322(b)(2) does not apply to a secured claim on a multi-unit property because, while one unit is her principal residence, the other unit is an income producing unit. Relying on Lomas Mortgage, Inc. v. Louis, 82 F.3d 1 (1st Cir. 1996), Scarborough argues that the anti-modification provision only applies where the real property in question is used exclusively as the debtor's principal residence. Conversely, relying on In re Macaluso, 254

[10] Scarborough also argues that the Mortgage's Family Rider (Assignment of Rents) section creates additional collateral sufficient to remove Chase Manhattan's secured claim from the protection of § 1322(b)(2). However, the Bankruptcy Court concluded, and Scarborough did not challenge the fact that there is no present assignment of leases. In re Scarborough, at 6, n.7. Therefore, we do not address whether a security interest in the leases would create additional collateral in personal property.

B.R. 799, 800 (Bankr. W.D.N.Y. 2000), Chase Manhattan argues instead that the anti-modification provision applies to any real property that is used as the debtor's principal residence. The Bankruptcy Court, relying on Litton Loan Servicing, LP v. Beamon, 298 B.R. 508, 512 (N.D.N.Y. 2003) and Brunson v. Wendover Funding, Inc. (In re Brunson), 201 B.R. 351, 353 (Bankr. W.D.N.Y. 1996), balanced the concerns of the parties and their legal authority and by focusing on the "intent of the parties at the time they entered into the mortgage agreement." In re Scarborough, at 7. The Court finds the Bankruptcy Court's approach preferable for the following reasons.

Once again, the current dispute revolves around the meaning of § 1322(b)(2)'s anti-modification provision. The anti-modification rule does not allow a debtor to bifurcate a creditor's claim where the claim is "secured only by a security interest in real property that is the debtor's principal residence." 11 U.S.C. § 1322(b)(2). Both the United States Supreme Court and the United States Court of Appeals for the Third Circuit clearly indicate that Congress intended the anti-modification provision to "'encourage the flow of capital into the home lending market,'" as distinguished from the commercial lending market, by reducing mortgagee's risk in Chapter 13 proceedings. See In re: Hammond, 27 F.3d. at 57 (quoting Nobelman, 113 S. Ct. at 2112 (Stevens, J., concurring). With

this in mind, a case-by-case analysis of whether the parties intended the mortgage to be primarily residential or primarily commercial in nature is the appropriate inquiry for applying § 1322(b)(2). See Litton Loan, 298 B.R. at 512 (explaining the purpose of § 1322(b)(2) and benefits of a case-by-case approach); see also In re Brunson, 201 B.R. at 353 (explaining the short comings of a bright line approach). The Brunson court also found that the case-by-case approach was preferred:

> The Court must focus on the predominant character of the transaction, and what the lender bargained to be within the scope of its lien. If the transaction was predominantly viewed by the parties as a loan transaction to provide the borrower with a residence, then the antimodification provision will apply. If, on the other hand, the transaction was viewed by the parties as predominantly a commercial loan transaction, then stripdown will be available. Such ruling serves the Congressional intent of encouraging home mortgage lending as illuminated by the Supreme Court in Nobelman.

In re Brunson, 201 B.R. at 354.

The cases relied on by the parties, Lomas and Macaluso, set forth bright line rule tests for applying § 1322(b)(2)'s anti-modification provision. The problem with this is that, in an effort to create simplicity and predictability, they fail to adequately safeguard equity. First, Chase Manhattan's reliance on Macaluso interprets § 1322(b)(2) too broadly. The Macaluso court attempted a plain meaning approach § 1322(b)(2). They found that the word "'only' modified 'secured'" and concluded

from this that the statute clearly applies to any mortgage secured by property that is used as a principal residence. See Macaluso, 254 B.R. at 800. The Macaluso approach places no limit on the reach of § 1322(b)(2) as long as property contains, and is in some way used as, a principal residence. This approach is problematic because no distinction is made between a residential and a commercial mortgage. Under Macaluso, "at least in theory, a commercial mortgage on an owner-occupied 100-unit complex would be excepted from modification, a result that would presumably not serve the purpose of buoying the residential lending market." Litton Loan, 298 B.R. at 512, n.2.

Second, Scarborough relied on the Lomas interpretation of § 1322(b)(2). The Lomas rule states that if mortgage covers any other property or income producing components beyond the principal residence, § 1322(b)(2) does not apply. Lomas, 82 F.3d at 7. This rule has been critiqued for its arbitrariness. See Litton Loan, 298 B.R. at 512 (explaining that the Lomas rule arbitrarily excludes multi-family residences that are both used as a principal residence and covered by a residential mortgage from the protections of § 1322(b)(2)). We agree that the Lomas approach is "inconsistent with the purpose of § 1322(b)(2), at least insofar as it would allow modification of mortgages that are indisputably residential in nature." See Id.

Lomas interpreted the meaning of § 1322(b)(2) by looking at

the subsequent legislative history found in the 1994 amendments to Chapter 11 that added a similar anti-modification clause to that Chapter. Id. at 6-7. However, as the Bankruptcy Court noted, that legislative history cites favorably to cases that used a multi-factor approach in order to determine whether the mortgagee considered the loan commercial or residential. See In re: Brunson, 201 B.R. at 353 (citing In re: Ramirez, 62 B.R. 668 (Bankr. S.D. Cal. 1986)). The subsequent legislative history of § 1322(b)(2), therefore, also encourages courts to take case-by-case approach to determining the application of the anti-modification provision.

Having concluded that the case-by-case approach is superior to the bright-line rule approaches of Lomas and Macaluso, the Court also concludes that the Bankruptcy Court properly determined the parties' intent at the time the Mortgage was executed. In making this determination, the Brunson Court listed several factors to consider:

> [W]hether the Debtor (to the lender's knowledge) owned other income producing properties or other properties in which [the Debtor] could choose to reside; whether [the Debtor] had a principal occupation other than as landlord, and the extent to which rental income or other business income produced from the real estate contributed to [the Debtor's] income; whether [the Debtor's] total income was particularly high or particularly low; whether the mortgage was handled through the commercial loan department or the residential mortgage loan department of the lender; whether the interest rates applied to the mortgage were home loan rates or commercial loan rates; the

> demographics of the market (e.g. are "doubles" a much more affordable "starter home" than a single, in that locale); and the extent to which, and purpose for which, potential business uses of the land . . . were considered by the lender.

Brunson, 201 B.R. at 353.

Incorporating these factors to the present case we rely on the Bankruptcy Court's finding of facts because they remained unchallenged by Scarborough's appeal.[11] The Bankruptcy Court found certain facts indicative of a commercial transaction. In re Scarborough, at 8. Chase Manhattan knew or should have known that it was lending against a multi-unit property when Scarborough made the purchase. Scarborough claims that she advised the bank of her intent to use the Property as an investment. She was enrolled in a real estate class at the Philadelphia Community College and she, eventually, rented the unit on the Property in 2000.

Based on the totality of the factors, however, the Bankruptcy Court was correct to conclude that the Scarborough's Mortgage is predominately residential, not commercial, in nature. See In re: Brunson, 201 B.R. at 354 (describing the standard to judge the factors on). Scarborough intended and succeeded to use the Property as her principal residence when she signed the

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[11] Scarborough's Appellate Brief challenges the legal inferences and conclusions that the Bankruptcy Court makes, however, Scarborough does not allege that any of the factual findings were made in clear error. (Appellate Br. at 15.)

Mortgage. She did not own more than one property or any other income producing properties. The Mortgage is a standard "Pennsylvania - Single Family - FNMA/FHLMC Uniform Instrument," with a "2-4 Family Rider (Assignment of Rents)" attached. These are standard forms used for residential purposes. Finally, Scarborough was employed full time as an Income Maintenance Worker for the City of Philadelphia. These facts militate in favor the Bankruptcy Court's legal conclusion that the Chase Manhattan's Mortgage was for residential, not commercial, purposes. Therefore, the fact that the Property had a second unit does not remove the protections of § 1322(b)(2) from Chase Manhattan's secured claim.

Accordingly, the Bankruptcy Court's decision that "Chase Manhattan's claim is subject to the protections of the anti-modification clause of § 1322(b)(2) and cannot be bifurcated pursuant to § 506(a)" is **AFFIRMED**.

IN THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

In re:	:	
	:	
FRANCES SCARBOROUGH,	:	
Debtor.	:	Misc. No. 03-228

O R D E R

AND NOW, this day of October 2004, in consideration of the record on appeal, as well as the appellant brief of Frances Scarborough (Doc. No. 4), the appellant brief of Chase Manhattan Mortgage Corporation (Doc. No. 5), Scarborough's Reply Brief, and for the reasons set forth in the foregoing Memorandum, it is hereby **ORDERED** that the decision of the Bankruptcy Court in the above captioned bankruptcy barring the bifurcation of Chase Manhattan Mortgage Corporation's claim into secured and unsecured components is **AFFIRMED**.

BY THE COURT:

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JAMES McGIRR KELLY, J.