

In re Pichhi; Modifications of Multi-Family Home Mortgages

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Introduction

In a decision with important implications for lenders in the real estate business, the Bankruptcy Appellate Panel for the First Circuit determined that debtors can strip down a creditor's under-secured claim in a multi-family dwelling to the appraised value of the property.¹ While the Bankruptcy Technical Corrections Act of 2010 ("BTCA") were in effect at the time of the decision, the panel decided the issue under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") because both parties argued the issue under the BAPCPA definitions and declined to raise the applicability of BTCA to the issue.² Specifically at issue in the case, *Pawtucket Credit Union v. Pichhi (In re Picchi)*, was whether the definitions introduced by Congress under the BAPCPA amendments brought multi-family dwellings within the definition of debtor's principal residence and by extension incidental property. In deciding the issue, the court relied heavily upon the pre-BAPCPA case of *Lomas Mortgage, Inc. v. Louis*,³ finding that the definitions of "debtor's principal residence" and "incidental property" introduced

¹ *Pawtucket Credit Union v. Picchi (In re Picchi)*, 448 B.R. 870 (B.A.P. 1st Cir. 2011).

² *See id.* at 872.

³ 82 F.3d 1 (1st Cir. 1996).

by BAPCPA did not alter the meaning of section 1322(b)(2), the anti-modification provision of the Code.⁴

To best understand the implications of the panel's decision it is necessary to first understand the relevant provisions of the Bankruptcy Code and the reasoning behind the decision. After reviewing these important matters we can then turn to the future impact that the *In re Picchi* decision may have in the future. Therefore, Part I of this memorandum will analyze the precedential case of *Lomas*, the landmark case of *Nobelman v. American Sav. Bank*⁵ and Bankruptcy Code provisions including, section 1322 anti-modification provision, section 506 bifurcation provision, section 101(13A)'s definition of debtor's principal residence, and section 101(27B)'s definition of incidental property. Next, part II of this memorandum will provide a detailed explanation of the panel's decision, including analyzing the relevant precedent, the arguments made, and the reasoning for deciding the issue under the BAPCPA instead of the BTCA. Finally, part III will look at how future courts may analyze the issue and decide the issue based on the BTCA while still looking to *In re Picchi* for guidance.

I: Background Analysis: Bankruptcy Code Provisions and Precedential Decisions

The bankruptcy appellate panel in *In re Picchi* addressed whether a multi-family dwelling would fall into the definition of debtor's principal residence contained in section 101(13A) when the debtor resided in only one of the units and rented out the second unit.⁶ Briefly reviewing the facts, *Picchi*, the debtor, had three liens on the property and when the property was appraised the value was sufficient only to secure the first lien on the property.⁷ Because of this the plan

⁴ See *In re Picchi*, 448 B.R. at 875; see also 11 U.S.C. § 1322(b)(2) (2006) (disallowing modification of debtor's principal residence).

⁵ 508 U.S. 324 (1993).

⁶ See *id.* at 871.

⁷ See *id.*

provided that Pawtucket, holder of the second lien, and the holder for the third lien had their secured claims reduced to zero pursuant to section 506(a).⁸ To appreciate the complications the panel faced in addressing this issue, it is important to examine the relevant provisions of the Bankruptcy Code that allow a debtor to modify the secured claim of a creditor. The court struggled to come to a clear interpretation for the definition of debtor’s principal residence because of the reference to incidental property and what this term encompassed.

A: Section 1322 anti-modification clause, section 506 valuation and *Nobelman v. American Savings Bank*

Traditionally, secured loans of personal residential property are not allowed to be stripped down in bankruptcy proceedings. By stripping down, or bifurcating a claim under section 506(a) a debtor is able to separate a claim into secured and unsecured portions based on the creditor’s interest in the property and the actual value of the property. By bifurcating the claim in a Chapter 13 plan, the debtor is essentially modifying the rights of the creditor’s that have an interest in the property.⁹ A debtor strips-off a claim when they strip a claim all the way down, so that the creditor is left with no secured claim in the property and only an unsecured claim, as was the case in *In re Picchi*.¹⁰ Anti-modification of such secured claims secured by a principal residence is the general rule provided for in section 1322 of the Bankruptcy Code.¹¹ Specifically, section 1322(b)(2) of the Bankruptcy Code provides 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 . . .*”¹² The landmark

⁸ See *id.*; see also 11 U.S.C. § 506(a).

⁹ See 11 U.S.C. § 506(a).

¹⁰ See *In re Picchi*, 448 B.R. at 873.

¹¹ See 11 U.S.C. § 1322(b)(2) (2005).

¹² *Id.* (emphasis added).

*Nobelman*¹³ decision addressed the issue regarding the ability to bifurcate of a secured claim of a debtor's principal residence. It held that section 506(a)¹⁴ valuation and bifurcation did not trump the anti-modification provision provided for by section 1322(b)(2).¹⁵ This is because the rights and obligations held by the creditor included more than the secured claim and thus bifurcation was not possible.¹⁶ However, *Nobelman* did not shed any guidance on when a claim is secured only by a security interest in real property that is the debtor's principal residence. However, later courts dealt with the issue of what is and is not considered a debtor's principal residence.

B: Lomas Mortgage, Inc. v. Louis

Similar to the issue in *In re Picchi*, the United States Court of Appeals for the First Circuit in *Lomas* had to determine whether a multi-family dwelling fell within the definition of debtor's principal residence, and therefore, if the claim could not be modified because of section 1322 of the Bankruptcy Code. The *Lomas* court held that section 1322(b)(2) did not apply to multi-unit homes because they did not qualify as a debtor's principal residence.¹⁷ To determine if a multi-family home could constitute a debtor's principal residence the court examined the proposed versions of the bill, the statutory language, and the legislative history.¹⁸ From this examination the court observed that the Senate compromised its more restrictive version of the bill with no modifications of any mortgage secured by real estate for the less restrictive version

¹³ 508 U.S. 324 (1993).

¹⁴ Section 506(a) provides, in relevant part: "An allowed claim of a creditor secured by a lien on property in which the estate has an interest ... is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property ... and is an unsecured claim to the extent that the value of such creditor's interest ... is less than the amount of such allowed claim." 11 U.S.C. § 506(a)(1).

¹⁵ See *Nobelman* 508 U.S. at 332.

¹⁶ See *id.* at 329.

¹⁷ See *Lomas Mortgage, Inc. v. Louis* 82 F.3d 1, 6–7 (1st Cir. 1996).

¹⁸ See *id.* at 7–8.

of no modification for principal residences.¹⁹ This did not answer the question of whether a multi-family home was considered a principal residence,²⁰ so the court turned to the changes made in the Bankruptcy Reform Act of 1994. The court noted that Congress referred favorably in legislative history to case law interpreting anti-modification provisions as not applying to multi-family homes in chapter 13 cases when it adopted a similar chapter 11 definition.²¹

Therefore, the court determined that it was the intent of Congress to allow modification of multi-family homes.²² The court was not troubled by the fact that the legislative history it relied upon was subsequent to the enactment of the provision it was analyzing, stating that, “subsequent Congressional declaration of an act's intent is entitled to great weight in statutory construction.”²³

C: BAPCPA Amendments of Debtor’s Principal Residence and Incidental Property

While the *In re Picchi* panel was guided by the *Lomas* decision, it needed to consider how the BAPCPA amendments may have changed the relevant definitions. Specifically, BAPCPA introduced new definitions for both debtor’s principal residence and incidental property.²⁴ Due to the new definitions, the panel had to decide if they brought multi-family

¹⁹ *See id.* at 5–6.

²⁰ *See id.* at 7.

²¹ *See* H.R. Rep. No. 835, 103d Cong., 2d Sess. 46 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3340, 3354 (“[t]his amendment conforms the treatment of residential mortgages in chapter 11 to that in chapter 13, preventing the modification of the rights of a holder of a claim secured only by a security interest in the debtor’s principal residence.”).

²² *See Lomas*, 82 F.3d at 7. “The 1994 Act evidences a deliberate choice on the part of Congress under Chapter 11 to exclude security interests in multi-unit properties like that here from the reach of the anti-modification provision based on its understanding that Chapter 13's anti-modification provision did not reach such security interests. To disregard such evidence would frustrate the uniform treatment under Chapters 11 and 13 of secured interests in debtors' principal residences that was so clearly Congress's aim in amending § 1123(b)(5).”

²³ *See id.* (citing *Roosevelt Campobello Int'l Park Comm'n v. U.S.E.P.A.*, 711 F.2d 431, 436-37 (1st Cir.1983)).

²⁴ *See Pawtucket Credit Union v. Picchi (In re Picchi)*, 448 B.R. 870, 872 (B.A.P. 1st Cir. 2011).

homes within debtor's principal residence.²⁵ To accomplish this, the court took a similar approach to the *Lomas* court, engaging in statutory interpretation of the new definitions.

The panel analyzed the BAPCPA definition of debtor's principal residence in section 101(13A), which provided that; "[t]he term 'debtor's principal residence' – (A) means a residential structure, including incidental property, without regard to whether that structure is attached to real property; and (B) includes an individual condominium or cooperative unit, a mobile home or manufactured home, or trailer."²⁶ When the court read the definition of debtor's principal residence together with the amendment of section 101(27B) for incidental property, which stated that, "[t]he term 'incidental property' means, with respect to a debtor's principal residence – (A) property commonly conveyed with a principal residence in the area where the real property is located; (B) all easements, rights, appurtenances, fixtures, rents, royalties, mineral rights, oil or gas rights or profits, water rights, escrow funds, or insurance proceeds; and (C) all replacements or additions[,]" the panel was left with the difficult task of interpreting Congress's intent as to whether these new definitions encompassed multi-family homes.²⁷ The panel's interpretation of the new definitions was the essential element that was argued by both parties.

II: The *In re Picchi* Decision

The facts of *In re Picchi* were extremely similar to *Lomas*. Both cases involved undersecured creditors of multi-family units that argued that the multi-family units fell within the definition of debtor's principal residence and therefore are barred from being modified by the

²⁵ *See id.*

²⁶ 11 U.S.C. § 101(13A) (2005).

²⁷ *See id.* at § 101(27B).

debtor.²⁸ At first glance it would then seem that the Bankruptcy Appellate Panel for the First Circuit would have an easy decision on its hands and quickly affirm Picchi’s plan to modify the claim of Pawtucket. However, because of the BAPCPA amendments, the panel had to undertake its own statutory interpretation, just as the *Lomas* court did fifteen years earlier.

Pawtucket advocated that the court adopt a plain meaning approach to interpreting the new definitions. Pawtucket argued inclusion of residential structure in the definition of debtor’s principal residence could encompass both single and multi-family dwellings.²⁹ Next, Pawtucket argued that rental units are “property commonly conveyed with a principal residence in the area where the real property is located,”³⁰ and therefore would be considered incidental property under section 101(27B).³¹ While the court admitted that both of these approaches were “plausible” interpretations of the new BAPCPA definitions, it ultimately rejected both suggestions.³²

Instead, the panel read the definition of debtor’s principal residence as one where subparagraph A was qualified by subparagraph B. Thus, it determined that residential structure was not a stand-alone term and had to be read with subparagraph B.³³ When the two subparagraphs are read together the court determined that a residential structure may simply refer to the space that a debtor’s actual living unit occupies.³⁴ The panel briefly entertained the reading Pawtucket suggested of incidental property, but ultimately decided the explanation given by the bankruptcy court was preferable. The bankruptcy court suggested that incidental property

²⁸ See *In re Picchi*, 448 B.R. at 874.

²⁹ See *id.*

³⁰ See 11 U.S.C. § 101(27B) (2005).

³¹ See *In re Picchi*, 448 B.R. at 875.

³² See *id.* at 874-75

³³ See *id.* at 874.

³⁴ See *id.*

simply “means objects like a ‘boiler, the attached garage, [or] the window treatments that are typically listed in a standard mortgage.’”³⁵

The panel determined that definitions of debtor’s principal residence and incidental property were neither clear nor unambiguous.³⁶ The court went so far as to read into section 1322 the definitions suggested by Pawtucket, to prove that the definitions were unclear and ambiguous. The result was the following:

[T]he 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 *a residential structure, including property commonly conveyed with a principal residence in the area where the real property is located, all easements, rights, appurtenances, fixtures, rents, royalties, mineral rights, oil and gas rights or profits, water rights, escrow funds or insurance proceeds, and all replacements or additions, without regard to whether that structure is attached to real property including an individual condominium or cooperative unit, a mobile or manufactured home, or trailer....*³⁷

The panel clearly stated that this new enhanced reading of section 1322(b)(2) did not provide the answer to whether a multi-family home that includes debtor’s principal residence could or could not be modified by a debtor.³⁸ Because the new BAPCPA definitions did not provide clear guidance on the issue and there was no evidence of Congressional intent to modify the existing law, the court cited the *Lomas* decision as the reason for continuing to hold that multi-family homes were not subject to the anti-modification provision of section 1322(b)(2).

One interesting aspect of the *In re Picchi* decision is the fact that it was decided under the BAPCPA amendments, even though the BTCA amendments were in effect at the time the

³⁵ *See id.* at 875.

³⁶ *See id.*

³⁷ *See id.*

³⁸ *See id.* at 875 n.12.

decision was rendered. The new amendments included a revision of the definition of debtor's principal residence, the key issue for the *In re Picchi* panel. Yet, the panel did not take the issue up under the BTCA amendments because neither party asked the court to determine the issue under the BTCA revised definitions.³⁹

III: Future Effects of the *In re Picchi* Decision

While following the reasoning of the *Lomas* court, the *In re Picchi* panel perhaps provided some guidance for future courts should the issue be litigated under the new BTCA amendments. *In re Picchi* has been repeatedly cited for the proposition that multi-family dwellings should not be included within the definition of debtor's principal residence.⁴⁰ That, however, could just be the start as courts will now start to deal with whether the BTCA amendments version of debtor's principal residence⁴¹ now encompasses multi-family dwellings.

Because the *In re Picchi* panel did not determine the outcome under the current BTCA amendments the issue could be ripe for litigation. However, the *In re Picchi* panel hinted that this might not be the case because of legislative history associated with the BTCA. The panel specifically noted that the legislative history of the BTCA, states that it was "not intended to enact any substantive changes to the Bankruptcy Code."⁴² Because the amendments were not meant to make any substantive changes to the Bankruptcy Code it is unlikely that it would upset

³⁹ *See id.* at 872.

⁴⁰ *See In re Hunt*, Bankruptcy No. 11 B 30609, 2011 WL 6176197 (Bankr. N.D. Ill. Dec. 9, 2011); *In re Banks*, Bankruptcy No. 11 B 34091, 2011 WL 5240269 (Bankr. N.D. Ill. Oct. 31, 2011); *In re Mobley*, Bankruptcy No. 11 B 34299, 2011 WL 5833976 (Bankr. N.D. Ill. Nov. 17, 2011).

⁴¹ Section 101(13A) now provides: "The term 'debtor's principal residence' – (A) means a residential structure if used as the principal residence by the debtor, including incidental property, without regard to whether that structure is attached to real property; and (B) includes an individual condominium or cooperative unit, a mobile or manufactured home, or trailer if used as the principal residence by the debtor."

⁴² *See In re Picchi*, 448 B.R. at 872 (citing 156 CONG. REC. H7158 (daily ed. Sept. 28, 2010) (statement of Rep. Smith)).

the now established precedent of *Lomas* and by extension *In re Picchi*. Additionally, it seems unlikely that the court would decide to start protecting mortgages made for properties that have multiple purposes.⁴³ For example, an owner of a large apartment building may reside within one of the apartments, yet the main purpose of the building is to produce income.⁴⁴ However, just because the court noted that no substantive changes were intended, that does not change the fact that the issue is still open to be challenged and could ultimately upset the holding of the *In re Picchi* panel.

Conclusion:

When a debtor of a multi-family dwelling seeks to modify the secured claim of a creditor it is likely that the court that hears the matter will need to follow the same road map laid out by both *Lomas* and *In re Picchi*. The court will be forced to conduct a statutory interpretation of the new definitions provided by the BTCA of debtor's principal residence and determine if the new definition is clear and unambiguous as to whether or not a multi-family dwelling qualifies as a principal residence. If the court determines that the new definition is not clear and unambiguous, (as it seems is likely from past history) than it is probable that the court will follow the precedent that such claims are able to be modified by following *In re Picchi* and *Lomas*. Therefore, the court is likely to still only protect real estate lenders when the lien the lender takes is secured solely by a unit that is the residence of the borrower. Courts will continue to allow borrower's to modify liens when secured by units other than the borrower's residence, as the lender should have known that the property would have been used for other purposes.

⁴³ See *In re Brunson*, 201 B.R. 351 (Bankr. W.D. N.Y. 1996).

⁴⁴ See *In re Kimbell*, 247 B.R. 35 (Bankr. W.D.N.Y. 2000) (holding that it is unlikely that Congressional intent was for the Bankruptcy Code's anti-modification provision to reach a 100-unit apartment complex simply because the debtor lived in one of the units).