IT IS SO ORDERED.

Dated: November 3, 2015

Jeffery P. Hopkins
United States Bankruptcy Judge

UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF OHIO
WESTERN DIVISION

In Re	:	
	:	
RANDALL L. LINDSEY	:	Case No. 15-10255
LYNETTE K. LINDSEY	:	Chapter 13
	:	Judge Hopkins
Debtors	:	
RANDALL LINDSEY	:	Adversary Case No. 15-1025
LYNETTE LINDSEY	:	
	:	
Plaintiffs	:	
	:	
vs.	:	
	:	
BENEFICIAL FINANCIAL I INC.	:	
	:	
	:	
Defendant	:	

MEMORANDUM OF DECISION ON ORDER DENYING MOTION TO DISMISS

This is an unusual adversary action brought within the context of a chapter 13 confirmation. Presently before the Court is a motion to dismiss ("Motion")(Doc. 8) the Plaintiffs' – chapter 13 Debtors, Randall and Lynette Lindsey("the Plaintiffs" or "the Lindseys") – complaint filed by the Defendant, Beneficial Financial I Inc. ("Beneficial"), the mortgage holder, pursuant to Fed. R. Civ. P. 12(b)(6). The Court must determine in this case whether a claim secured by a mortgage on the Debtors' principal residence, among other property rights defined under state law, can be modified under 11 U.S.C. § 1322(b)(2) in order to decide the outcome of the Motion.

Beneficial holds a first mortgage secured by the Lindseys' single family residence. The Lindseys' chapter 13 plan proposes a cram down of Beneficial's claim. Beneficial argues that its secured claim is protected from modification by § 1322(b)(2)(which precludes modification of "a claim secured only by a security interest in real property that is the debtor's principal residence"). According to the Lindseys, § 1322(b)(2)'s anti-modification provision does not apply because Beneficial's mortgage encumbers more than just the residence itself. The mortgage also purports to encumber escrow funds for property taxes and hazard insurance. The mortgage provides: "The [escrow funds] are pledged as additional security for the sums secured by this Mortgage." The parties agreed to the conditional confirmation of the chapter 13 plan, subject to modification pending the outcome of this adversary proceeding.

JURISDICTION

The Court has jurisdiction over this action pursuant to 28 U.S.C. § 1334(b) and the Standing Order of Reference entered in this District. Pursuant to 28 U.S.C. § 157(b)(2)(B), (K), (L), this is a core proceeding in which the Court possesses the authority to enter final judgment.[1] This memorandum constitutes this Court's findings

[1] *Stern v. Marshall*, 131 S. Ct. 2594 (2011) and its progeny are not implicated because this action does not involve a "Stern claim." *See Executive Benefits Ins. Agency v. Arkison*, 134 S. Ct. 2165, 2170 (2014)("Stern claim" is a core proceeding that could have been brought as a suit at common law). The applicability of § 1322(b)(2)'s anti-modification clause is a core

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of fact and conclusions of law under Fed. R. Bankr. P. 7052.

RULE 12(B)(6)

A claim must be plausible to avoid dismissal under Rule 12(b)(6). *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007). A claim is plausible if the complaint includes factual allegations that support a reasonable inference of liability. *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009).

ISSUE

The issue presented is whether the Lindseys' complaint states a plausible action for modification of Beneficial's secured claim. The Court believes that it does.

THE SPLIT OF AUTHORITY

Several courts have addressed the issue presented by the parties. The majority holds that a mortgagee forfeits the protection of § 1322(b)(2) if the mortgage also creates a security interest in escrow funds. *See In re Martin*, 444 B.R. 538, 543 (Bankr. M.D.N.C. 2011); *In re Bradsher*, 427 B.R. 386, 389-92 (Bankr. M.D.N.C. 2010); *In re Thomas*, 344 B.R. 386, 390-92 (Bankr. W.D. Pa. 2006); *In re Hughes*, 333 B.R. 360, 363-64 (Bankr. M.D.N.C. 2005); *In re Brown*, 311 B.R. 282, 285-86 (Bankr. M.D. Fla. 2004); *In re Donadio*, 269 B.R. 336, 337-39 (Bankr. M.D. Pa. 2001); *In re Stewart*, 263 B.R. 728, 731-33 (Bankr. W.D. Pa. 2001); *In re Reed*, 247 B.R. 618, 622-24 (Bankr. E.D. Pa. 2000); *In re Steslow*, 225 B.R. 883, 885-86 (Bankr. E.D. Pa. 1998); *In re Lewandowski*, 219 B.R. 99, 102 (Bankr. W.D. Pa. 1998); *In re Crystian*, 197 B.R. 803, 806 (Bankr. W.D. Pa. 1996); *In re Pinto*, 191 B.R. 610, 613-14 (Bankr. D.N.J. 1996); *In re Dent*, 130 B.R. 623, 628-29 (Bankr. S.D. Ga. 1991); *but see In re Inglis*, 481 B.R. 480, 482-85 (Bankr. S.D. Ind. 2012); *In re Lunger*, 370 B.R. 649, 649-51 (Bankr. M.D. Pa. 2007); *In re Townsville*, 268 B.R. 95, 126 n.31 (Bankr. E.D. Pa. 2001); *In re Abruzzo*, 245 B.R. 201, 208-09 (Bankr. E.D. Pa. 1999); *In re Rodriguez*, 218 B.R. 764, 772-78 (Bankr. E.D. Pa. 1998); *In re Halperin*, 170 B.R. 500, 502 (Bankr. D. Conn. 1994). The majority looks to whether the escrow funds constitute real property under applicable state law. If not, the claim is subject

[1](...continued)
proceeding, but not a suit that could have been brought at common law.

to modification because it is not, in the words of § 1322(b)(2), "secured only by a security interest in real property." The minority does not view the escrow funds as collateral that is independent from the real property.

THE 2005 AMENDMENTS

In 2005, Congress amended the Bankruptcy Code to add, among other things, some definitions relevant to § 1322(b)(2). First, Congress defined "debtor's principal residence" as "a residential structure . . . including incidental property[.]" *See* 11 U.S.C. § 101(13A)(A). Second, Congress defined "incidental property" to include "all . . . escrow funds[.]" *See* 11 U.S.C. § 101(27B)(B). The minority-view decisions decided after this change hold that, as a matter of federal law, the escrow funds constitute real property. *See In re Inglis*, 481 B.R. 480, 482-85 (Bankr. S.D. Ind. 2012)("Congress has effectively broadened the definition of real property for the purposes of implementing § 1322(b)(2)."); *In re Lunger*, 370 B.R. 649, 649-51 (Bankr. M.D. Pa. 2007)(same). Beneficial urges the Court to adopt this position.

REINHARDT

Although the Sixth Circuit has not addressed whether a security interest in escrow funds forfeits the protection of the anti-modification clause, it has concluded that the Bankruptcy Code's definition of "debtor's principal residence" does not determine whether property constitutes "real property" under § 1322(b)(2). *See In re Reinhardt*, 563 F.3d 558, 563 (6th Cir. 2009)("no matter how broad the definition of 'debtor's principal residence,' [the collateral] must also be 'real property' for the anti-modification provision to apply."). Because the Bankruptcy Code does not define the term "real property," applicable state law determines whether the collateral is real property. *See Reinhardt*, 563 F.3d at 561-63.

In light of *Reinhardt* this Court is compelled to follow the majority-view, concluding that escrow funds do not constitute real property as a matter of federal law.[2]

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[2] Beneficial concedes that "escrow funds almost certainly do not constitute real property under the law of any state." *See* Doc. 10 at 6; s*ee also Stevens v. Suntrust Mortgage, Inc. (In re Stevens),* Ch. 13 Case No. 14-41709, Adv. No. 14-4059, slip op. at 17-22 (Bankr. N.D. Ohio Feb.
(continued...)

DAVIS

Beneficial contends that *In re Davis*, 989 F.2d 208 (6th Cir. 1993) precludes the Debtors from modifying its claim. In *Davis*, a deed of trust also secured "the Hereditaments and Appurtenances, rents, royalties, profits, and fixtures thereto appertaining." The Sixth Circuit concluded that the encumbrance of these interests did not forfeit the anti-modification protection of § 1322(b)(2) because the interests were "incidental" to the real property and "inextricably bound to the real property itself as part of the possessory bundle of rights." *Davis*, 989 F.2d at 212-213. For that reason, the Court concluded that the incidental interests related did not constitute additional security. *Id*.

The facts of this case are distinguishable from *Davis*. The escrow funds are funds advanced by the Debtors to pay their property taxes and hazard insurance premiums. These funds are not, in the words of *Davis*, "inextricably bound to the real property itself as part of the possessory bundle of rights." *See In re Brown*, 311 B.R. 282, 285 (Bankr. M.D. Fla. 2004)("Although its purpose is to protect and preserve a mortgagee's interest in the real estate, an escrow account is clearly not an item which is inextricably bound to the real property itself as part of the possessory bundle of rights.").[3]

KREITZER

Beneficial also relies upon *In re Kreitzer*, 489 B.R. 698 (Bankr. S.D. Ohio 2013)(Humphrey, J.). In *Kreitzer*, a mortgage assigned to the mortgagee "any compensation, settlement, award of damages, or proceeds paid by any third party . . . for . . . misrepresentations of, or omissions as to, the value and/or condition of the Property." Judge Humphrey found this to be "the type of 'incidental benefit' which [according to *Davis*] is 'inextricably bound to the real property itself as part of the

[2](...continued)
5, 2015)(concluding that escrow funds are personal property, not real property, under Ohio law).

[3] *Davis* also concluded that a covenant to maintain hazard insurance did not forfeit the protection of the anti-modification provision. *Davis*, 989 F.2d at 212. The Court distinguished the covenant from a security interest in the insurance premiums, "reserv[ing] for another day the issue of whether additional interests in insurance premiums . . . might serve as 'additional security' for purposes of section 1322(b)(2)." *Id.*

possessory bundle of rights.'" *Kreitzer*, 489 B.R. at 705.

Escrow funds are distinguishable from "compensation, settlement, award of damages, or proceeds paid by any third party . . . for . . . misrepresentations of, or omissions as to, the value and/or condition of the Property." Judge Humphrey astutely noted that the latter does not add to the value of the collateral. *Id*. at 705-06. Like hazard insurance proceeds, it merely replaces the lender's expected valuation of the property. *Id*. at 706. It is not collateral "in addition to the value of the real estate." *Id*.

Escrow funds are different. Unlike the proceeds of hazard insurance, which replace the value of the collateral, funds earmarked to pay the premiums for that insurance are not exclusively replacement funds. The premiums represent a source of funds in addition to the value of the real estate, particularly if the property never sustains a casualty loss. *See Stevens v. Suntrust Mortgage, Inc. (In re Stevens)*, Ch. 13 Case No. 14-41709, Adv. No. 14-4059, slip op. at 15 (Bankr. N.D. Ohio Feb. 5, 2015)("Escrow funds [unlike the collateral in *Kreitzer*] are in no way related to diminishment, damage or destruction of the real property and do not serve the function of replacement security. Accordingly, escrow funds are more akin to . . . additional security irrespective of the value of the real property.").

BENEFICIAL'S ALTERNATIVE ARGUMENTS

Beneficial raises two alternative arguments. First, it questions whether it even possesses a security interest in the escrow funds as a matter of law. Second, it questions whether the complaint states a claim when it fails to allege that the Debtors actually advanced escrow funds.

1. Does Beneficial Possess a Security Interest in the Escrow Funds?

At least three decisions hold that a mortgagee with a purported security interest in escrow funds does not forfeit the protection of § 1322(b)(2)'s anti-modification clause where applicable state law provides that the debtor/mortgagor retains no rights in the escrow funds. *See In re Ferandos*, 402 F.3d 147 (3d. Cir. 2005); *In re Rosen*, 208 B.R. 345 (Bankr. D.N.J. 1997); *In re Libby*, 200 B.R. 562 (Bankr. D.N.J. 1996). If the mortgagor retains no rights in the escrow funds, then a security interest never attaches because the mortgagor cannot encumber property that the mortgagor does not

own. *Id.* All three of these decisions are premised upon New Jersey law.

One context where title to escrow funds arises is when the mortgagor claims that the mortgagee owes earnings or profits on the funds. *See* Ferdinand S. Tinio, Annotation, *Rights in Funds Representing "Escrow" Payments Made By Mortgagor in Advance to Cover Taxes or Insurance*, 50 A.L.R. 3d 697 (1973). Ohio has an unpublished decision on point. *See Portman v. Akron Savs. & Loan*, No. 8417, 1977 WL 199009 (Ohio Ct. App. Sept. 14, 1977). *Portman* looked to whether a trust or a debtor-creditor relationship was established under Ohio law. *Id*. at *1. If a debtor-creditor relationship is established, then the mortgagee is free to commingle the funds as the exclusive owner and retain all earnings and profits. *Id*. at *1-2. In a different case, the Supreme Court of Ohio has held that the distinction between trust or debt is drawn as follows:

> If one person pays money to another, it depends upon the manifested intention of the parties whether a trust or a debt is created. If the intention is that the money shall be kept or used as a separate fund for the benefit of the payor or a third person, a trust is created. If the intention is that the person receiving the money shall have unrestricted use thereof, being liable to pay a similar amount whether with or without interest to the payor or to a third person, a debt is created. The intention of the parties will be ascertained by a consideration of their words and conduct in the light of all the circumstances.

Squire v. Oxenreiter, 130 Ohio St. 475, 478-79 (1936).

An examination of the mortgage in this case leads the Court to believe that the parties intended to create a trust, not a creditor-debtor relationship. The mortgage does not give Beneficial unrestricted use of the funds. Instead, it provides that "the Funds[4] shall be held in an institution the deposits or accounts of which are insured or guaranteed." It further provides that "Lender shall apply *the Funds* to pay said taxes

[4] The mortgage defines "Funds" as "a sum equal to one-twelfth of the yearly taxes and assessments (including condominium and planned unit development assessments, if any) which may attain priority over this Mortgage and ground rents on the Property, if any, plus one-twelfth of yearly premium installments for hazard insurance, plus one-twelfth of yearly premium installments for mortgage insurance, if any[.]"

[and] insurance premiums[.]" (Emphasis added.) A debtor-creditor relationship would not require Beneficial to apply "the Funds" to the tax and insurance obligations. Instead, Beneficial could commingle the escrow funds and use any of Beneficial's funds to satisfy the obligations. As further evidence of a trust, the mortgage provides: "Upon payment in full of all sums secured by this Mortgage, Lender shall promptly refund to Borrower any *Funds* held by Lender." (Emphasis added.) Again, Beneficial is required to return specific "Funds" upon satisfaction of the note, not simply a specific amount of money from any source of funds held by Beneficial.

Therefore, the mortgage in this case does not create a debtor-creditor relationship whereby the Debtors divested themselves of any interest in the funds. Instead, under Ohio law, Beneficial holds the funds in trust and the Debtors retained an interest in the same. Because the Debtors retained an interest, the mortgage created a valid security interest in the escrow funds.

2. Does the Complaint Fail to State a Claim Without Alleging an Advance of Escrow Funds

At least two courts have addressed the issue of whether a mortgagor must actually deliver escrow funds before seeking to modify a mortgage that purportedly secures escrow funds. *See In re Brown*, 311 B.R. 282 (Bankr. M.D. Fla. 2004); *In re Stewart*, 263 B.R. 728 (Bankr. W.D. Pa. 2001). In both cases the mortgage provided that "[t]he Funds are pledged as additional security for the sums secured by this Mortgage" – the exact language contained in the Lindseys' mortgage. However, based upon applicable state law, the courts reached different conclusions.

Brown concludes that delivery of the escrow funds is a prerequisite to modification because, under Florida law, no security interest attaches until an escrow fund actually exists. *Brown*, 311 B.R. at 287 ("no security interest may attach to collateral that has not come into existence"). *Stewart* concludes that delivery of the escrow funds is not a prerequisite to modification because, under Pennsylvania law, the mortgagee acquired an interest, even if only an equitable interest, when the mortgagor pledged the funds. *Stewart*, 263 B.R. at 731-32 (mortgagee acquired an interest when debtors conveyed the pledge by signing mortgage).

Ohio case law does not appear to address the rights of a creditor in pledged collateral that does not yet exist. However, if asked to decide the issue, this Court

believes that the Supreme Court of Ohio would conclude that a mortgagee acquires an interest in non-existent, pledged property at the time the mortgage is executed. The applicable Restatement provides:

> (3) A contract to pledge a chattel not in existence or which the prospective pledgor does not own or have the power of pledging does not create a pledge, but if the chattel is sufficiently identified and if an obligation exists or arises which the contract was intended to secure, the prospective pledgee acquires an equitable interest . . . in the chattel when it comes into existence or when the prospective pledgor gets either the title to it or the power of pledging it.

Restatement (First) of Security § 10 (1941). At first glance, it appears that the creditor's interest may not arise until the property comes into existence. However, the official comment to the section cited provides that "[t]here is a security interest as a result of the contract itself which is superseded by the equitable interest in the chattel when it is acquired." *Id*. at cmt. (3)(emphasis added). Thus, under this construction, Beneficial obtained a security interest upon execution of the mortgage, regardless of whether the escrow funds exist.

CONCLUSION

For the foregoing reasons, the Motion will be **DENIED**. An order to this effect will be entered.

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