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**ANOTHER THORN IN THE
“SEMANTIC BRIAR PATCH”
OF THE HANGING PARAGRAPH:¹
IS NEGATIVE EQUITY A PURCHASE MONEY
SECURITY INTEREST?**

I. INTRODUCTION

In August 2006, Lisa Kay Weiser purchased a 2006 Toyota RAV4 for around \$30,000.² When Lisa discovered that she could not afford the payments on the RAV4, she traded it in for a 2006 Pontiac G6 at Van Chevrolet. The “sticker” price of the Pontiac was \$14,434.50. Van Chevrolet gave Lisa \$21,000 as a trade-in allowance for the RAV4, leaving a balance of \$9,031.64 due and owing on her loan to Toyota Motor Finance for the RAV4. Van Chevrolet added this amount to Lisa’s loan for the Pontiac, along with \$2,555 for an extended warranty and \$750 for “gap” insurance.³ Lisa financed a total of \$26,771.14 at 10.55% interest, payable in seventy-five monthly installments of \$491.13 each. Shortly after the transaction, Van Chevrolet assigned its interest in the loan to Community America.

Lisa filed for Chapter 13 bankruptcy protection on March 12, 2007. Community America filed a claim for \$28,251.24.⁴ In her Chapter 13 plan, Lisa proposed to pay \$15,295 (the current value of the Pontiac) as a secured claim to Community America, and the remainder of the balance due to Community America would be paid as an unsecured claim. Community America objected to confirmation of Lisa’s plan, arguing that it was entitled to full payment of its claim under § 1325(a) of the Bankruptcy Code.⁵ A provision in § 1325(a) disallows the sort of bifurcation that Lisa proposed for Community America’s claim. The provision applies if the claim is a purchase money security interest on a personal vehicle purchased within 910 days of

1. Courts and commentators have given the “hanging paragraph” in 11 U.S.C. § 1325(a) many scurrilous nicknames. This particular one was given by Judge Dunn in *In re Johnson*, 380 B.R. 236, 238 (Bankr. D. Or. 2007).

2. The facts are taken from *In re Weiser*, 381 B.R. 263, 265 (Bankr. W.D. Mo. 2007). These facts represent the typical situation where a debtor finances negative equity with her new car loan, and this Comment will refer to the same factual scenario throughout.

3. Gap insurance covers the difference between a car’s value and the amount owed to the lienholder if the car were to be destroyed in an accident or by other means. *In re Weiser*, 381 B.R. at 265 n.1.

4. Presumably, the claim includes amounts for interest, late charges, and attorney’s fees. Lisa did not object to the amount of the claim.

5. The Bankruptcy Code is contained in Title 11 of the United States Code. Future statutory references are to the 2006 version of Title 11, unless otherwise indicated.

the bankruptcy filing. The dispute in Lisa's case centered on whether Community America had a purchase money security interest in the \$9,031.64 it financed for the remaining amount due on the RAV4 loan (called "negative equity").⁶ The bankruptcy court ruled that it was and that Lisa's Chapter 13 plan had to provide for payment of Community America's entire claim.

The issue of whether a creditor has a purchase money security interest in the negative equity portion of a car loan prompted a great deal of litigation. The early majority of bankruptcy courts held that negative equity was not a purchase money security interest.⁷ But as the decisions were appealed, nearly every circuit court to hear the issue has held that negative equity can form the basis for a purchase money security interest. As of this writing, eight of the nine circuit courts to consider the issue have held that negative equity from a trade-in that is rolled into a loan for the purchase of a new car is purchase money debt that is not subject to bifurcation under § 1325(a).⁸ The Ninth Circuit came to the opposite conclusion, however, and two of the circuit decisions drew vigorous dissents.⁹ Despite the clear majority in the circuit

6. Negative equity is the term used for the amount by which the debt exceeds the value of the collateral at the time of the trade-in. *In re Callicott*, 386 B.R. 232, 236 (Bankr. E.D. Mo. 2008); see also *In re Hampton*, No. 07-14990, 2008 Bankr. LEXIS 2551, at *5 (Bankr. S.D. Ohio June 16, 2008) ("Negative equity" is . . . the amount by which the outstanding loan balance . . . exceeds the value of the trade-in vehicle.").

7. 2 BARKLEY CLARK & BARBARA CLARK, THE LAW OF SECURED TRANSACTIONS UNDER THE UNIFORM COMMERCIAL CODE ¶ 12.05[10][b], at 12-113 (perm. ed., rev. vol. 2009); see also *In re Crawford*, 397 B.R. 461, 467 (Bankr. E.D. Wis. 2008); *In re Hernandez*, 388 B.R. 883, 885 (Bankr. C.D. Ill. 2008); *In re Munzberg*, 388 B.R. 529, 548 (Bankr. D. Vt. 2008); *In re Padgett*, 389 B.R. 203, 213 (Bankr. D. Kan. 2008); *In re Callicott*, 386 B.R. 232, 237 (Bankr. E.D. Mo. 2008); *In re Look*, 383 B.R. 210, 219 (Bankr. D. Me. 2008); *In re Conyers*, 379 B.R. 576, 582 (Bankr. M.D.N.C. 2007); *In re Hayes*, 376 B.R. 655, 672-73 (Bankr. M.D. Tenn. 2007); *In re Sanders*, 377 B.R. 836, 864 (Bankr. W.D. Tex. 2007); *In re Blakeslee*, 377 B.R. 724, 731 (Bankr. M.D. Fla. 2007); *In re Pajot*, 371 B.R. 139, 154 (Bankr. E.D. Va. 2007); *In re Acaya*, 369 B.R. 564, 571 (Bankr. N.D. Cal. 2007); *In re Price*, 363 B.R. 734, 741 (Bankr. E.D.N.C. 2007); *In re Vega*, 344 B.R. 616, 623 (Bankr. D. Kan. 2006).

8. *Nuvell Credit Corp. v. Westfall (In re Westfall)*, 599 F.3d 498, 500 (6th Cir. 2010); *Howard v. AmeriCredit Fin. Servs. (In re Howard)*, 597 F.3d 852, 858 (7th Cir. 2010); *Reiber v. GMAC, LLC (In re Peaslee)*, 585 F.3d 53, 57 (2d Cir. 2009); *Dale v. Ford Motor Credit Co. (In re Dale)*, 582 F.3d 568, 575 (5th Cir. 2009); *Ford Motor Credit Co. v. Mierkowski (In re Mierkowski)*, 580 F.3d 740, 743 (8th Cir. 2009); *Ford v. Ford Motor Credit Corp. (In re Ford)*, 574 F.3d 1279, 1286 (10th Cir. 2009); *Wells Fargo Fin. Acceptance v. Price (In re Price)*, 562 F.3d 618, 629 (4th Cir. 2009); *Graupner v. Nuvell Credit Corp. (In re Graupner)*, 537 F.3d 1295, 1301 (11th Cir. 2008). The Second Circuit certified the question to the New York Court of Appeals, which held that the negative equity was a purchase money security interest. *Reiber v. GMAC, LLC (In re Peaslee)*, 913 N.E.2d 387, 388 (N.Y. 2009).

9. *Americredit Fin. Servs. v. Penrod (In re Penrod)*, No. 08-60037, 2010 U.S. App. LEXIS 14588 (9th Cir. July 16, 2010); *In re Mierkowski*, 580 F.3d at 743 (Bye, J., dissenting); *In re Ford*, 574 F.3d at 1286 (Tymkovich, J., dissenting); see also *Nuvell Credit Co. v. Callicott (In re Callicott)*, 580 F.3d 753, 755 (8th Cir. 2009) (Bye, J., concurring) (Judge Bye indicated that he was still unpersuaded by the majority opinion, but that he was bound by the decision in *In re Mierkowski*). The New York Court of Appeals decision also drew a harsh dissent. *Reiber*, 913 N.E.2d at 391

courts that negative equity can form the basis for a purchase money security interest, the resolution of the issue is still, as the Eleventh Circuit put it, a “close call.”¹⁰

I disagree with the conclusion reached by the majority of the circuit courts, and I concur with the Ninth Circuit and the majority of bankruptcy courts that negative equity can form the basis of a purchase money security interest.¹¹ Negative equity is essentially antecedent debt that is not the type of obligation covered by the definition of purchase money security interest in the Uniform Commercial Code. Unfortunately, given that so many circuit courts have held that negative equity is purchase money debt, the remaining circuits are unlikely to come to the opposite conclusion.¹² Action from Congress is necessary to clarify what it meant when it wrote the term into the Bankruptcy Code.

In Part II of this Comment, I will provide an explanation of the statutory background at issue in this debate, the significance of a purchase money security interest, and the interplay between state and federal law; in Part III, I will discuss the reasoning given by the circuit courts and analyze the merits of their various arguments; and in Part IV, I will explore some additional considerations in making the determination of whether negative equity financing can form the basis of a purchase money security interest.

II. STATUTORY FRAMEWORK AND OTHER PRELIMINARY MATTERS

A. *The Purchase Money “Super-Priority”*

For the purposes of this Comment, there are three types of creditors in a bankruptcy proceeding: unsecured creditors, secured creditors, and purchase money creditors. Unsecured creditors lend money to the debtor based on nothing more than the debtor’s promise to repay the money. The creditor’s return on his investment depends on the debtor’s continued solvency.

(Smith, J., dissenting).

10. *In re Graupner*, 537 F.3d at 1301.

11. Courts are also divided on the question of whether amounts financed for gap insurance and service contracts should be classified as a purchase money security interest. Compare *In re Spratling*, 377 B.R. 941, 943 (Bankr. M.D. Ga. 2007) (funds loaned for insurance and warranty can be a purchase money security interest); *In re Macon*, 376 B.R. 778, 781–83 (Bankr. D.S.C. 2007) (same); *In re Murray*, 352 B.R. 340, 347–49, 354 (Bankr. M.D. Ga. 2006) (same), with *In re Honcoop*, 377 B.R. 719, 724 (Bankr. M.D. Fla. 2007) (funds loaned for insurance cannot be a purchase money security interest); *In re White*, 352 B.R. 633, 648 (Bankr. E.D. La. 2006) (same). Interestingly, the Bankruptcy Appellate Panel for the Tenth Circuit concluded that, while negative equity is a purchase money security interest, funds advanced for gap insurance and a service contract are not. *Ford Motor Credit Co. v. Miller (In re Miller)*, No. KS-09-003, 2009 Bankr. LEXIS 3627, at *8, 13–14 (B.A.P. 10th Cir. Nov. 19, 2009).

12. See *In re Dale*, 582 F.3d at 575 n.8 (“Our conclusion is bolstered by general prudential concerns with creating unnecessary circuit splits.”). But see *In re Penrod*, 2010 U.S. App. LEXIS 14588, at *5–6 (“We acknowledge that our decision creates a circuit split, and we do not do this lightly.”).

Unsecured creditors cannot turn to the debtor's assets or belongings to satisfy the debt obligation without going through a complex scheme of state procedures for obtaining a judgment, attaching a judgment lien, and executing on the judgment lien. If the debtor goes bankrupt, the unsecured creditor receives a pro rata share of the debtor's estate along with the rest of the unsecured creditors.

Secured creditors, on the other hand, can look to either the debtor or a piece of the debtor's property for payment. The debtor typically grants the creditor a property interest, called a "security interest," in a piece of the debtor's property, the collateral.¹³ If the debtor stops making his payments on the debt, the creditor can simply foreclose on the collateral.¹⁴ If the creditor has leftover money after selling the collateral and satisfying the loan, he must return it to the debtor. But if, as is often the case, the proceeds of the sale are not enough to satisfy the loan obligation, the debtor still owes to the creditor the remaining amount, called a "deficiency."¹⁵ Obviously, it is in the secured creditor's best interest for the outstanding balance on the loan to be less than the market value of the property.

Two or more creditors may take a security interest in the same piece of property. Problems may arise, however, when the debtor defaults on the loans, and the piece of property must be seized and sold. If the value of the property is less than the amount due on the loans, who gets paid first? Article 9 of the Uniform Commercial Code (U.C.C.), which governs security interests, sets forth several rules for determining which creditor is "first in line" to receive its payment. In general, the U.C.C. follows the "first in time, first in line" rule, which provides that the first creditor to perfect his security interest is the first in line to be paid from the proceeds of the collateral.¹⁶

This rule makes it difficult for a debtor, typically a business, to buy a new piece of machinery or equipment on credit if any new assets are covered by an after-acquired property clause.¹⁷ Anyone lending money to a debtor to buy a new machine cannot take a first-position security interest in the machine because the blanket security interest was filed first.¹⁸ The new lender would

13. 4 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 30-1, at 3-4, § 30-2, at 14-15 (6th ed. 2010).

14. *Id.* § 34-4, at 412.

15. *Id.* Depending on the type of property and the type of loan, the loan may be either recourse or nonrecourse. Recourse loans allow the creditor to go back to the debtor to demand payment of the deficiency after the property is sold. If the loan is nonrecourse, the creditor's seizure of the property satisfies the loan in full, regardless of the remaining amount due or the value of the collateral. BLACK'S LAW DICTIONARY 1020-21 (9th ed. 2009). Nonrecourse loans, therefore, are riskier for the creditor because of the risk that collateral will depreciate in value.

16. U.C.C. § 9-322 (2001); 4 WHITE & SUMMERS, *supra* note 13, § 33-3, at 323-26.

17. U.C.C. § 9-204 (2001); 4 WHITE & SUMMERS, *supra* note 13, § 33-3, at 327.

18. 4 WHITE & SUMMERS, *supra* note 13, § 33-4, at 331.

have to get in line behind the blanket creditor before he could be paid in the event of a default.

Enter the purchase money security interest (PMSI). The PMSI functions as a “super-priority” security interest by upsetting the normal first-in-time rule.¹⁹ Section 9-103 of the U.C.C. provides that a PMSI has priority over a prior security interest even though the PMSI creditor perfected its security interest later.²⁰ A creditor with a PMSI has a first-in-line priority interest in the machinery over liens that were first in time.²¹ The concept of PMSI is based on equitable notions—“it protects vendors of goods from after-acquired property clauses generally used by banks and financiers.”²²

In addition to exemption from the first-in-time rule, holders of PMSIs enjoy several other benefits. First, a lender with a PMSI in consumer goods does not need to file a financing statement to perfect its lien.²³ Second, debtors in bankruptcy can avoid nonpossessory, non-PMSIs in certain assets, but they cannot avoid nonpossessory PMSIs.²⁴ Because of these powerful advantages, PMSIs should be narrowly construed to avoid unfair treatment to other creditors.

B. The “Hanging Paragraph” in Section 1325(a)

Prior to 2005, the amount of a secured creditor’s claim in a Chapter 13 bankruptcy depended on the value of the creditor’s collateral. Section 506(a) of the Bankruptcy Code provides in pertinent 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.²⁵

This section is important for debtors that owe more on a loan than the

19. See Keith G. Meyer, *A Primer on Purchase Money Security Interests Under Revised Article 9 of the Uniform Commercial Code*, 50 KAN. L. REV. 143, 149–50 (2001); see also Juliet M. Moringiello, *A Tale of Two Codes: Examining § 522(f) of the Bankruptcy Code, § 9-103 of the Uniform Commercial Code and the Proper Role of State Law in Bankruptcy*, 79 WASH. U. L.Q. 863, 883 (2001) (“The purchase-money secured party has an exalted status under Article 9 of the U.C.C.”).

20. 4 WHITE & SUMMERS, *supra* note 13, § 33-4, at 330.

21. See U.C.C. § 9-322.

22. *Americredit Fin. Servs., Inc. v. Penrod (In re Penrod)*, 392 B.R. 835, 845 (B.A.P. 9th Cir. 2008).

23. U.C.C. § 9-309(a) (2001).

24. 11 U.S.C. § 522(f)(1)(B) (2006). In fact, the Federal Trade Commission considers the taking of a non-PMSI in certain household goods to be an unfair credit practice. 16 C.F.R. § 444.2(a)(4) (2010).

25. 11 U.S.C. § 506(a)(1) (2006).

collateral is worth. Under this section, once a debtor files bankruptcy, the secured creditor's claim is split into two parts: a secured claim up to the value of the collateral, and an unsecured claim for the remaining portion. This practice of separating, or "bifurcating," a creditor's lien into secured and unsecured portions is known as "lien stripping" or "cramdown" because the value of the creditor's lien is "stripped" or "crammed down" to the value of the collateral. For example, if Lisa's Chapter 13 case was filed before 2005, Community America would have a secured claim up to the value of the Pontiac on the date of Lisa's filing, which Lisa asserted was \$15,295.²⁶ Community America then would have an unsecured claim for the remaining balance of the loan.

The secured status of a claim is particularly important in a Chapter 13 case. Section 1325(a)(5) provides that a Chapter 13 plan cannot be confirmed unless the secured creditor approves the plan, the debtor surrenders the property subject to the secured claim, or the plan provides for payment in full of the secured portion of the claim. A creditor is not likely to approve a Chapter 13 plan that does not pay the entire amount of its claim, so the plan must pay the secured portion of the claim in full if a debtor wants to keep the encumbered property. The unsecured portion of a crammed-down claim, however, need not be paid in full before the plan can be confirmed—the unsecured portion is paid pro rata with all of the other unsecured claims.²⁷

In 2005, Congress enacted the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).²⁸ BAPCPA dramatically altered the previous cramdown practice for automobiles by adding an unnumbered paragraph at the end of § 1325(a) (the "hanging paragraph").²⁹ The hanging paragraph provides:

For purposes of paragraph (5), section 506 shall not apply

26. *In re Weiser*, 381 B.R. 263, 266 (Bankr. W.D. Mo. 2007).

27. This cramdown process essentially mimics the same result as if the creditor had foreclosed on the vehicle to satisfy the debt after the debtor defaulted, but the debtor gets to keep the property. *In re Sanders*, 377 B.R. 836, 844 (Bankr. W.D. Tex. 2007). The creditor receives full payment of the market value of the vehicle over the life of the Chapter 13 plan, and is left with an unsecured deficiency claim for the portion over and above the market value of the car.

28. Pub. L. No. 109-8, 119 Stat. 23 (2005). The statute was enacted on April 20, 2005, and applies to bankruptcy cases commenced on or after October 17, 2005. *See id.* at 23, 216.

29. This paragraph has been referred to as "§ 1325(a)(9)," "§ 1325(a)(*)," the "unnumbered paragraph," and the "hanging paragraph." *Graupner v. Nuvel Credit Corp.* (*In re Graupner*), 537 F.3d 1295, 1296 n.1 (11th Cir. 2008); *see also, e.g., Nuvel Credit Corp. v. Westfall* (*In re Westfall*), 599 F.3d 498, 501 (6th Cir. 2010) ("The relevant provision appears as an unnumbered paragraph following § 1325(a), now commonly referred to as the 'hanging paragraph' . . ."). Much controversy has surrounded the meaning of this paragraph, but many of these issues are outside the scope of this Comment, which is only concerned with the effect of negative equity on the PMSI status of the claim.

to a claim described in that paragraph if the creditor has a purchase money security interest securing the debt that is the subject of the claim, the debt was incurred within the 910-day [sic] preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle³⁰

The effect of this paragraph is to exempt a creditor from the cramdown effects of § 506(a) when the requirements of the paragraph are satisfied.³¹ The claim must meet four requirements to be exempted from bifurcation under § 506(a): (1) The debt must be secured by a PMSI; (2) the debt must have been incurred within 910 days of the date of the bankruptcy filing; (3) the collateral must consist of a motor vehicle; and (4) the collateral must be acquired for the personal use of the debtor.³² If the requirements are met, the hanging paragraph functions as an “anti-cramdown” provision—because § 506(a) no longer applies, the debtor is prevented from bifurcating the creditor’s claim into secured and unsecured portions, regardless of the collateral’s value on the date of filing.³³ The entire claim, including the portion over and above the value of the collateral, must be paid through the Chapter 13 plan.³⁴ If the hanging paragraph applies in Lisa’s case, Lisa’s Chapter 13 plan would have to provide for payment of Community America’s full claim of \$28,251.24, regardless of the value of the car on the date of filing.

30. 11 U.S.C. § 1325(a) (2006). In addition to the fact that the paragraph is not numbered like the rest of § 1325(a), there seems to be a missing noun after “910-day.” Congress likely meant to say “910-day period.” The hanging paragraph also applies to “any other thing of value” purchased within one year of filing. *Id.* This Comment is concerned only with the automobile provision, though the analysis would apply with the same force to any other asset where the loan included antecedent debt unrelated to the purchase price of the collateral.

31. Section 506(a) is the only section in the Bankruptcy Code that gives secured creditors an allowed claim. Presumably, Congress meant that the bifurcation of claims allowed by § 506(a) does not apply, not that the entire section does not apply. *See* Citifinancial Auto v. Hernandez-Simpson, 369 B.R. 36, 41 (D. Kan. 2007); 8 COLLIER ON BANKRUPTCY ¶ 1325.06[1][a] (Alan N. Resnick & Henry J. Sommer eds., rev. 15th ed. 2008).

32. The second, third, and fourth requirements are easily determined, although some litigation has resulted from the question of whether a vehicle was purchased for the personal use of the debtor. *See, e.g., In re Matthews*, 378 B.R. 481, 489 (Bankr. D.S.C. 2007) (discussing whether a vehicle was purchased for the debtor’s personal use). This Comment is concerned only with the question of whether the first requirement, purchase money status, is satisfied when negative equity is financed in addition to the purchase price.

33. At least one commentator has argued that the hanging paragraph merely exempts the claim from § 506(a), and the court is free to apply any other method of valuation except the one prescribed in § 506(a). Jean Braucher, *Rash and Ride-Through Redux: The Terms for Holding on to Cars, Homes and Other Collateral Under the 2005 Act*, 13 AM. BANKR. INST. L. REV. 457, 469–74 (2005). Braucher argues that courts should apply the wholesale value to cars in bankruptcy because a lender foreclosing on the car would sell it at wholesale after repossession. *Id.* This Comment continues under the widely accepted view that by exempting the claim from application of § 506(a), bifurcation of the claim is not allowed and the creditor has a fully secured claim, regardless of the value of the collateral.

34. *See* 11 U.S.C. § 1325(a)(5).

C. Defining Purchase Money Security Interest—State Law vs. Federal Law

Unfortunately, the Bankruptcy Code does not define the term “purchase money security interest.”³⁵ The phrase “purchase money security interest” is a term of art, and it has no “ordinary or generally understood” meaning in the context of the Bankruptcy Code.³⁶ Purchase money status was intended to resolve conflicts over which creditor’s claim would receive priority—and thus receive payment first—in the event of a default.³⁷ The PMSI super-priority facilitates the harmony and coexistence of after-acquired property clauses that reduce risk in commercial loans and credit transactions for new equipment and machinery. The Bankruptcy Code injected confusion by affording purchase money creditors additional benefits that are unrelated to the priority of conflicting security interests. Indeed, the term is used only three times in the Code.³⁸

The bankruptcy provisions that place the most emphasis on purchase money status relate to consumer transactions,³⁹ but the U.C.C. provides little guidance regarding PMSIs in the consumer context.⁴⁰ Courts are left to grapple with the status of transactions for which PMSIs were never meant to have any relevance because conflicting priorities in consumer goods are a rarity.

The Supreme Court long ago ruled that “property rights in the assets of a bankrupt’s estate” are a matter of state law.⁴¹ Security interests are essentially property interests, so the extent of a creditor’s security interest is a question of state law. But the question of whether negative equity might be part of a PMSI in a consumer vehicle does not arise outside of bankruptcy law, leaving a dearth of state law on the issue.⁴²

When the state law on a subject is unsettled, a federal court has four options: (1) It can abstain from deciding the issue and refer the parties to state

35. See 11 U.S.C. § 101 (2006). The term is used in only two other places in the Code, § 522(f)(1)(B) and § 1110(d)(2).

36. *Dale v. Ford Motor Credit Co. (In re Dale)*, 582 F.3d 568, 573 (5th Cir. 2009).

37. See *supra* Part II.A.

38. 11 U.S.C. § 522(f)(1)(B) (2006) (allowing a debtor to avoid a “nonpossessory, nonpurchase-money security interest” if the debt encumbers an exempt asset); 11 U.S.C. § 1110(d)(2) (2006) (allowing creditors to repossess certain types of aircraft in Chapter 11 proceedings); 11 U.S.C. § 1325(a) (hanging paragraph).

39. 11 U.S.C. §§ 522(f)(1)(B), 1325(a).

40. Section 9-103 contains detailed rules for non-consumer goods transactions regarding payment allocation and mixed transactions that contain purchase money and non-purchase money components. Section 9-103(h) explains that the U.C.C. is deliberately silent regarding certain rules for PMSIs in the consumer context.

41. *Butner v. United States*, 440 U.S. 48, 54 (1979).

42. Indeed, there is a dearth of state law on PMSIs in general. I conducted a search of all state cases on LexisNexis for the term “purchase money security interest,” and the search yielded only 783 results. The same search in all federal cases yielded 2,257 results.

court; (2) it can certify the question to the highest court of the state; (3) it can try to predict how the state court will decide the issue; or (4) it can make the decision for the state court.⁴³ The first option cannot be used to solve the PMSI question because the federal courts have exclusive jurisdiction over bankruptcy proceedings.⁴⁴ The second option is not realistic because it would require certification to all fifty states before the law on the issue would be settled.⁴⁵ The federal courts addressing the negative equity issue are therefore left attempting to apply the nearly nonexistent state law to find an answer to the question.

The problem with turning to state law is that the U.C.C. drafters specifically cautioned against using section 9-103 to determine whether a creditor holds a PMSI in bankruptcy proceedings. In Official Comment 8, the drafters explained their hesitance to include consumer goods in certain provisions of section 9-103:

This section addresses only whether a security interest is a “purchase-money security interest” under this Article, primarily for purposes of perfection and priority. . . . Whether a security interest is a “purchase-money security interest” under other law is determined by that law. . . . The Bankruptcy Code does not expressly adopt the state law definition of “purchase-money security interest.” Where federal law does not defer to this Article, this Article does not, and could not, determine a question of federal law.⁴⁶

Indeed, the definition of “purchase money security interest” has become a matter of federal interpretation. The federal courts that purport to interpret the laws of different states rely on federal authority, rather than state law, for their opinions.⁴⁷ Even the lone state court to address the issue relied solely on

43. Jeffrey C. Alexander, Note, *The Law/Fact Distinction and Unsettled State Law in the Federal Courts*, 64 TEX. L. REV. 157, 160–65 (1985).

44. 28 U.S.C. § 1334 (2006).

45. See, e.g., *Reiber v. GMAC, LLC (In re Peaslee)*, 547 F.3d 177 (2d Cir. 2008). The Second Circuit noted the absence of state law on the negative equity issue and certified the question to the New York Court of Appeals. *Id.* at 186–87. The length of time for a question to be certified and answered is also a relevant consideration. Peaslee filed her Chapter 13 petition on July 11, 2006, the New York Court of Appeals did not answer the certified question until June 24, 2009, *Reiber v. GMAC, LLC (In re Peaslee)*, 913 N.E.2d 387 (N.Y. 2009), and the Second Circuit did not reverse the bankruptcy court decision until October 9, 2009, *Reiber v. GMAC, LLC (In re Peaslee)*, 585 F.3d 53 (2d Cir. 2009).

46. U.C.C. § 9-103 cmt. 8 (2001).

47. *Dale v. Ford Motor Credit Co. (In re Dale)*, 582 F.3d 568, 575 n.8 (5th Cir. 2009) (“Our conclusion is bolstered by general prudential concerns with creating unnecessary circuit splits.”); *Ford Motor Credit Co. v. Mierkowski (In re Mierkowski)*, 580 F.3d 740, 743 (“This court strives to maintain uniformity in the law among the circuits, whenever reasoned analysis will allow.”) (internal quotation marks and citation omitted).

federal cases in reaching its conclusions.⁴⁸ But only one case examining the negative equity issue has seriously considered whether a federal rule ought to be adopted.⁴⁹ Instead, the courts purport to base their decisions on the state versions of U.C.C. section 9-103.

Further illustrating the need for a federal rule is the fact that all fifty states have adopted the relevant provisions of the U.C.C.⁵⁰ But the lack of state law on the meaning of PMSI has led different bankruptcy courts in the same district to render different interpretations of the same law.⁵¹ Congress can and should define “purchase money security interest” in the Bankruptcy Code. Until it does, however, courts must look to state law—and only state law—to define the extent of a creditor’s security interest because it is a property right.

48. See *In re Peaslee*, 913 N.E.2d at 389–91.

49. See *In re Westfall*, 376 B.R. 210, 212 (Bankr. N.D. Ohio 2007). Courts grappling with other issues raised by the hanging paragraph have advocated a national rule. See *AmeriCredit Fin. Servs. v. Long (In re Long)*, 519 F.3d 288, 291 (6th Cir. 2008) (suggesting a national rule regarding the consequences of surrendering a vehicle covered by the hanging paragraph).

50. All fifty states (and the District of Columbia) have adopted § 9-103 of the U.C.C., which defines the term “purchase money security interest.” ALA. CODE § 7-9A-103 (LexisNexis 2006); ALASKA STAT. § 45.29.103 (2008); ARIZ. REV. STAT. ANN. § 47-9103 (2005); ARK. CODE ANN. § 4-9-103 (2001); CAL. COM. CODE § 9103 (West 2002); COLO. REV. STAT. § 4-9-103 (2009); CONN. GEN. STAT. ANN. § 42a-9-103a (West 2009); DEL. CODE ANN. tit. 6, § 9-103 (2005); D.C. CODE § 28-9-103 (2001); FLA. STAT. ANN. § 679.1031 (West 2003); GA. CODE ANN. § 11-9-103 (2002); HAW. REV. STAT. ANN. § 490:9-103 (LexisNexis 2009); IDAHO CODE ANN. § 28-9-103 (2001); 810 ILL. COMP. STAT. ANN. 5/9-103 (West 2004); IND. CODE ANN. § 26-1-9.1-103 (LexisNexis 2005); IOWA CODE ANN. § 554.9103 (West 2001); KAN. STAT. ANN. § 84-9-103 (Supp. 2008); KY. REV. STAT. ANN. § 355.9-103 (LexisNexis 2008); LA. REV. STAT. ANN. § 10:9-103 (2002); ME. REV. STAT. ANN. tit. 11, § 9-1103 (Supp. 2009); MD. CODE ANN., COM. LAW. § 9-103 (LexisNexis 2002); MASS. GEN. LAWS ANN. ch. 106, § 9-103 (West 2007); MICH. COMP. LAWS ANN. § 440.9103 (West 2003); MINN. STAT. ANN. § 336.9-103 (West 2002); MISS. CODE ANN. § 75-9-103 (2002); MO. ANN. STAT. § 400.9-103 (West 2003); MONT. CODE ANN. § 30-9A-103 (2009); NEB. REV. STAT. § 9-103 (2001); NEV. REV. STAT. ANN. § 104.9103 (LexisNexis 2007); N.H. REV. STAT. ANN. § 382-A:9-103 (2004); N.J. STAT. ANN. § 12A:9-103 (West 2004); N.M. STAT. § 55-9-103 (2001); N.Y. U.C.C. LAW § 9-103 (Consol. Supp. 2009); N.C. GEN. STAT. § 25-9-103 (2007); N.D. CENT. CODE § 41-09-03 (Supp. 2009); OHIO REV. CODE ANN. § 1309.103 (LexisNexis 2009); OKLA. STAT. ANN. tit. 12A, § 1-9-103 (West 2001); OR. REV. STAT. § 79.0103 (2007); 13 PA. CONS. STAT. ANN. § 9103 (West 2003); R.I. GEN. LAWS § 6A-9-103 (2001); S.C. CODE ANN. § 36-9-103 (2003); S.D. CODIFIED LAWS § 57A-9-103 (2004); TENN. CODE ANN. § 47-9-103 (2001); TEX. BUS. & COM. CODE ANN. § 9.103 (Vernon 2002); UTAH CODE ANN. § 70A-9a-103 (2009); VT. STAT. ANN. tit. 9A, § 9-103 (2001); VA. CODE ANN. § 8.9A-103 (2001); WASH. REV. CODE ANN. § 62A.9A-103 (West 2003); W. VA. CODE ANN. § 46-9-103 (LexisNexis 2007); WIS. STAT. § 409.103 (2007–2008); WYO. STAT. ANN. § 34.1-9-103 (2009).

A few states have adopted a slightly modified version, but the definition of purchase money security interest remains the same. See *infra* note 190.

51. Compare *In re Ford*, 387 B.R. 827, 833 (Bankr. D. Kan. 2008) (negative equity included in PMSI), and *In re Dunlap*, 383 B.R. 113, 119 (Bankr. E.D. Wis. 2008) (same), with *In re Padgett*, 389 B.R. 203, 213 (Bankr. D. Kan. 2008) (negative equity not included in PMSI), and *In re Crawford*, 397 B.R. 461, 467 (Bankr. E.D. Wis. 2008) (same).

III. FINDING A MEANING FOR “PURCHASE MONEY SECURITY INTEREST”

The “plethora of cases”⁵² addressing the negative equity issue that have been decided since the BAPCPA was enacted are split into two categories. The first group of courts—the Ninth Circuit and the early majority of bankruptcy courts—holds that the negative equity portion of an auto loan cannot form the basis of a purchase money security interest.⁵³ The second group, which includes eight of the circuit decisions to date, holds that the negative equity portion of the loan does not alter the purchase money nature of the security interest, and that the entire claim is subject to the anti-cramdown provisions of the hanging paragraph. The arguments advanced on each side of the issue are invariable from one case to the next.⁵⁴ This Part provides an overview and analysis of the arguments that the circuit courts have relied on to determine that a PMSI can include negative equity, ultimately concluding that the reasoning of the circuit courts is flawed and the better holding is that negative equity cannot be included in a PMSI.

A. Official Comment 3 and the (Non)Exhaustive List of Expenses

Because the term “purchase money security interest” is not defined in the Bankruptcy Code, courts look to state law for the definition.⁵⁵ Every state has adopted section 9-103 of the U.C.C. without substantial revision.⁵⁶ Thus, each of the courts to address the issue is essentially examining the same law.

52. *In re Myers*, 393 B.R. 616, 618 (Bankr. S.D. Ind. 2008). In fact, the issue has generated nearly ninety opinions from bankruptcy courts, district courts, and circuit courts. *See, e.g., infra* note 53.

53. *See AmeriCredit Fin. Servs. v. Penrod (In re Penrod)*, No. 08-60037, 2010 U.S. App. LEXIS 14588 (9th Cir. July 16, 2010); *Nuvell Credit Co. v. Callicott (In re Callicott)*, 396 B.R. 506, 510 (E.D. Mo. 2008); *Bank of America v. Look*, No. 08-129-P-H, 2008 WL 2789477 (D. Me. July 17, 2008); *Citifinancial Auto v. Hernandez-Simpson*, 369 B.R. 36, 48 (D. Kan. 2007); *In re McCauley*, 398 B.R. 41, 45 (Bankr. D. Colo. 2008); *In re Crawford*, 397 B.R. 461, 467 (Bankr. E.D. Wis. 2008); *In re Busby*, 393 B.R. 443, 452 (Bankr. S.D. Miss. 2008); *In re Brodowski*, 391 B.R. 393, 403–04 (Bankr. S.D. Tex. 2008); *In re Mancini*, 390 B.R. 796, 805 (Bankr. M.D. Pa. 2008); *In re Hernandez*, 388 B.R. 883, 885 (Bankr. C.D. Ill. 2008); *In re Munzberg*, 388 B.R. 529, 548 (Bankr. D. Vt. 2008); *In re Look*, 383 B.R. 210, 219 (Bankr. D. Me. 2008); *In re Johnson*, 380 B.R. 236, 250 (Bankr. D. Or. 2007); *In re Lavigne*, No. 07-30192, 2007 WL 3469454, at *8 (Bankr. E.D. Va. Nov. 14, 2007); *In re Mitchell*, 379 B.R. 131, 142 (Bankr. M.D. Tenn. 2007); *In re Conyers*, 379 B.R. 576, 582 (Bankr. M.D.N.C. 2007); *In re Hayes*, 376 B.R. 655, 672–73 (Bankr. M.D. Tenn. 2007); *In re Sanders*, 377 B.R. 836, 864 (Bankr. W.D. Tex. 2007); *In re Blakeslee*, 377 B.R. 724, 731 (Bankr. M.D. Fla. 2007); *In re Kellerman*, 377 B.R. 302, 303 (Bankr. D. Kan. 2007); *In re Pajot*, 371 B.R. 139, 154 (Bankr. E.D. Va. 2007); *In re Acaya*, 369 B.R. 564, 571 (Bankr. N.D. Cal. 2007); *In re Price*, 363 B.R. 734, 741 (Bankr. E.D.N.C. 2007); *In re Vega*, 344 B.R. 616, 623 (Bankr. D. Kan. 2006).

54. For example, Professor Ingrid Hillinger from Boston College Law School indicated that she had filed the same amicus brief in three circuit cases. Ingrid Michelsen Hillinger, *The Meaning of “Purchase Money Security Interest” Under Section 1325(a)(9)(*) (a.k.a. the Hanging Paragraph)* (2008) (unpublished manuscript, on file with author).

55. *See supra* Part II.C.

56. *See supra* note 50. The only real deviation that some states have made is to eliminate the consumer/non-consumer distinction in section 9-103. *See infra* note 190.

Article 9 of the U.C.C. was revised in 2001. Prior to the revision, the definition of “purchase money security interest” had two prongs: (1) an interest “taken or retained by the seller of the collateral to secure all or part of its price,” and (2) an interest taken by a third party who “gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.”⁵⁷ The first prong protected sellers who financed the sale themselves, and the second prong protected third-party financiers, e.g., banks and other lenders. Creditors asserting a PMSI could prevail if they satisfied either prong.

Revised Article 9 defines “purchase-money security interest” via a more circuitous route.⁵⁸ Section 9-103(b) provides that “[a] security interest in goods is a purchase-money security interest . . . to the extent that the goods are purchase-money collateral with respect to that security interest.” “Purchase-money collateral” is defined as “goods or software that secures a purchase-money obligation incurred with respect to that collateral.”⁵⁹ “Purchase-money obligation” is defined as “an obligation of an obligor incurred as all or part of the price of the collateral or for value given to enable the debtor to acquire rights in or the use of the collateral if the value is in fact so used.”⁶⁰ Revised Article 9 simply eliminates the distinction between the seller and the third-party lender, allowing either to take a PMSI for the price of the collateral or the value given to enable the debtor to acquire the collateral.⁶¹

The text of the U.C.C. provides little guidance to determine whether something is part of the “price of the collateral” or the “value given to enable the debtor to acquire rights in the collateral” such that it becomes part of the PMSI. Comment 3 to section 9-103 provides more insight. Comment 3 provides that

the “price” of collateral or the “value given to enable” includes obligations for expenses incurred in connection with acquiring rights in the collateral, sales taxes, duties, finance

57. U.C.C. § 9-107 (1972).

58. U.C.C. § 9-103 (2001).

59. U.C.C. § 9-103(a)(1).

60. U.C.C. § 9-103(a)(2).

61. See U.C.C. § 9-103. A few debtors have tried to argue that Revised Article 9 retains the distinction, and that because the PMSI was originally taken by the dealer (who is the seller), the lender has a PMSI for only the price of the collateral. See, e.g., *Dale v. Ford Motor Credit Co.* (*In re Dale*), 582 F.3d 568, 573–74 (5th Cir. 2009). The argument has not been successful. See *id.* at 574 (“[T]he creditor prevails if the debt at issue satisfies either prong.”); see also *Ford v. Ford Motor Credit Corp.* (*In re Ford*), 574 F.3d 1279, 1284 n.3 (10th Cir. 2009) (asserting that the terms “price” and “value given to enable” are equivalent). But see *AmeriCredit Fin. Servs. v. Penrod*, No. 08-60037, 2010 U.S. App. LEXIS 14588, at *15 (9th Cir. July 16, 2010) (holding that the “price” prong applies only to sellers and the “value given” prong applies to third-party financiers).

charges, interest, freight charges, costs of storage in transit, demurrage, administrative charges, expenses of collection and enforcement, attorney's fees, and *other similar obligations*.⁶²

Comment 3 goes on to provide that “[t]he concept of ‘purchase-money security interest’ requires a close nexus between the acquisition of collateral and the secured obligation.”⁶³ The circuit courts have generally found that negative equity is included in the price of the collateral, it is value given to enable the debtor to acquire the collateral, and it bears a “close nexus” to the financing transaction. As I explain below, negative equity does not pass any of these tests.

1. Price of the Collateral

There is no question that Comment 3 to the U.C.C. does not include negative equity in the list of things that can be included in the price of the collateral or the value given to enable purchase of the collateral.⁶⁴ Whether negative equity fits in the laundry list of examples given in the comment is a matter of how a court views the connection between the examples listed in Comment 3.

a. Eiusdem Generis

Almost without fail, debtors have attempted to invoke the canon of statutory construction known as *eiusdem generis*. The doctrine of *eiusdem generis* provides that “[w]here general words follow specific words in a statutory enumeration, the general words are construed to embrace only objects similar in nature to those objects enumerated by the preceding specific words.”⁶⁵ Therefore, the phrase “other similar obligations” at the end of the list must be construed to include only obligations that are similar to the obligations specifically enumerated in Comment 3. Debtors argue that the enumerated obligations are best categorized as “transaction costs.” Negative equity is not analogous to the rest of the items because it is not a typical cost of completing the transaction, such as sales taxes, finance charges, and administrative expenses.

The circuit courts have flatly rejected the debtors’ arguments, but for differing reasons. The Fifth Circuit rejected a debtor’s attempt to invoke the canon, finding that “the listed expenses in Comment 3 have no common

62. U.C.C. § 9-103 cmt. 3 (emphasis added). Roughly half of the states specifically included the comments in their official state version of the U.C.C. statutes. Most annotated versions of the state statutes published by West or Lexis include the U.C.C. comments. *See supra* note 50.

63. U.C.C. § 9-103 cmt. 3.

64. *See id.*

65. 2A NORMAN J. SINGER & J.D. SHAMBIE SINGER, STATUTES AND STATUTORY CONSTRUCTION § 47:17, at 358–60 (7th ed. 2007).

feature beyond an attenuated connection to the acquisition or maintenance of the vehicle.”⁶⁶ It held that negative equity has the same “attenuated connection” to the acquisition of the vehicle. Similarly, the Eleventh Circuit found that the list in Comment 3 is not “exhaustive,” and that it constitutes “merely examples” of additional components of the price of the collateral.⁶⁷ The court cited the inclusion of attorney’s fees in the list as evidence that the term “price” should be construed broadly. The inclusion of attorney’s fees “belies the notion that price or value is narrowly viewed as only those [traditional] expenses that *must* be paid to drive the car off the lot.”⁶⁸

The Fourth Circuit, on the other hand, found that the items listed in Comment 3 do have a common connection as “transaction costs” for the purchase of the collateral.⁶⁹ Like taxes, duties, interest, and freight charges, negative equity, the Fourth Circuit concluded, is simply a cost associated with the transaction, and therefore negative equity falls within the definition provided in Comment 3.⁷⁰

The Tenth Circuit also found a connection between the items in Comment 3. It held that the enumerated expenses are incurred so that the creditor may realize the value of its security interest.⁷¹ While the Tenth Circuit’s characterization of the connection between the items in Comment 3 is probably the best of the opinions to date, the court improperly characterized negative equity as being among the expenses incurred so that the creditor can realize the value of its security interest.

The court held that “[t]he discharge of negative equity clears the title of the trade-in vehicle, permitting the creditor to realize the value of the vehicle it receives as part of the trade.”⁷² There are a couple of problems with this statement. First, the statement assumes that the creditor is the one that receives the trade-in. It is true that the dealership may in some instances finance the transaction, but the loan is more often than not immediately sold to a bank or other financial institution.⁷³ So the fact that the negative equity

66. *In re Dale*, 582 F.3d at 574.

67. *Graupner v. Nuvel Credit Corp.* (*In re Graupner*), 537 F.3d 1295, 1302 (11th Cir. 2008).

68. *Id.* (internal quotation marks omitted) (alteration in original).

69. *Wells Fargo Fin. Acceptance v. Price* (*In re Price*), 562 F.3d 618, 627 (4th Cir. 2009).

70. *Id.* Interestingly, the Tenth Circuit recognized the strength of the debtor’s argument that all of the specific items in Comment 3 are transaction costs, but it refused to limit the breadth of the phrase “other similar obligations” to transaction costs because the term “transaction costs” was not used. *Ford v. Ford Motor Credit Corp.* (*In re Ford*), 574 F.3d 1279, 1285 (10th Cir. 2009) (“Had the drafters of the U.C.C. intended to limit a purchase-money security interest to cash price plus transaction costs, they could easily have done so.”).

71. *In re Ford*, 574 F.3d at 1285.

72. *Id.*

73. Indeed, none of the cases that made their way to the circuit level were pursued by dealerships themselves. Rather, they were pursued by lending institutions, though many of the

allows the dealer to realize the full value of the trade-in vehicle is in no way related to the security interest that the bank takes in the new vehicle. The trade-in allows the dealership, not the secured creditor, to realize the full value of the trade-in. The secured creditor has no interest in the trade-in and does not care what value the dealership receives from a trade-in that is not the creditor's collateral.

Second, in the cases involving negative equity, the security interest is in the new vehicle. Financing negative equity from the trade-in does not allow the creditor to realize the value of its security interest in the new vehicle. Negative equity is for the benefit of the dealer (with regard to the old vehicle only) and for the benefit of the debtor (so that she may buy a new car without having to pay completely pay off the old one first).

As Judge Tymkovich noted in his dissent from the Tenth Circuit's opinion, each expense in the list "adds no particular value for either the buyer or the seller but is instead simply the cost of using the price mechanism."⁷⁴ Things like sales taxes, duties, freight charges, costs of storage in transit, demurrage, and administrative charges must be paid so the collateral can be delivered to the buyer. The other items in the list are expenses charged by the secured creditor itself. Finance charges, interest, expenses of collection and enforcement, and attorney's fees are costs that allow the secured creditor to realize the value of his security interest because they make it worth the creditor's while to actually lend money to the debtor. Negative equity, on the other hand, is "a transfer of money for value."⁷⁵ The creditor provides money to pay off the balance on the preexisting loan, and the debtor promises to pay the money back, with interest, and grants the creditor a security interest in the collateral.

The financing of negative equity is "completely unrelated to the price of the [collateral] and its financing or the costs associated with transfer of title."⁷⁶ The Ninth Circuit adopted this view in holding that the items in Comment 3 are transaction costs related to the actual purchase of the vehicle, while negative equity is separable from the purchase transaction.⁷⁷ Thus, it cannot be akin to the itemized costs in Comment 3.

b. In Pari Materia

Many of the courts to address the negative equity issue have found that the

institutions are solely in the business of motor vehicle loans.

74. *In re Ford*, 574 F.3d at 1289 (Tymkovich, J., dissenting) (internal quotation marks omitted).

75. *Id.*

76. *Id.*

77. *AmeriCredit Fin. Servs., Inc. v. Penrod (In re Penrod)*, No. 08-60037, 2010 U.S. App. LEXIS 14588, at *11 (9th Cir. July 16, 2010).

term “price” as it is used in the U.C.C. is ambiguous because “the extent or reach of the term is uncertain.”⁷⁸ They then turn to a canon of statutory interpretation, known as *in pari materia*, which allows them to construe the U.C.C. provisions in accordance with price as it is defined in other statutes.⁷⁹ Statutes are read *in pari materia* when they relate to the same person, class of persons, or subject.⁸⁰

The courts using *in pari materia* to find the meaning of price have looked to state retail installment sales act (RISA) statutes and the federal Truth in Lending Act (TILA).⁸¹ For example, in *Reiber v. GMAC*, the New York Court of Appeals turned to the New York Motor Vehicle Retail Installment Sales Act (MVRISA), which includes in “cash sale price” the “unpaid balance of any amount financed under an outstanding motor vehicle loan agreement or motor vehicle retail installment contract.”⁸² The court reasoned that cash sale price includes negative equity under the MVRISA, so the negative equity could be part of the price of the collateral under the U.C.C.⁸³ Similarly, in *In re Graupner*, the bankruptcy court turned to the definition of “cash sale price” in the Georgia Motor Vehicle Sales Finance Act. The court held that “the Georgia General Assembly intended . . . to permit negative equity in a trade-in vehicle to be added to the cash sales price of a new vehicle without precluding the financing creditor or its assignee from taking a purchase money security interest in the new vehicle.”⁸⁴

The courts also find support for their position in TILA.⁸⁵ TILA directs the Board of Governors of the Federal Reserve to promulgate regulations for disclosure of credit terms to consumers.⁸⁶ The regulations under TILA provide that the “total sale price” includes the sum of the cash price and any other amounts financed by the creditor.⁸⁷ The courts conclude that because negative equity is an amount financed by the creditor, it is included in cash sale price under TILA.⁸⁸ When reading TILA together with the U.C.C., they

78. See *In re Graupner*, 356 B.R. 907, 919 (Bankr. M.D. Ga. 2006).

79. 2B SINGER & SINGER, *supra* note 65, § 51:1, at 196.

80. *Id.* § 51:3, at 235–37.

81. 15 U.S.C. § 1601 (2006).

82. *Reiber v. GMAC, LLC (In re Peaslee)*, 913 N.E.2d 387, 390 (N.Y. 2009) (quoting N.Y. PERS. PROP. LAW § 301(6) (Consol. Supp. 2009)).

83. *Id.*

84. *In re Graupner*, 356 B.R. 907, 923 (Bankr. M.D. Ga. 2006), *aff'd*, *Graupner v. Nuwell Credit Corp. (In re Graupner)*, 537 F.3d 1295, 1289 (11th Cir. 2008).

85. 15 U.S.C. § 1601.

86. 15 U.S.C. § 1604(a) (2006).

87. 12 C.F.R. § 226.18(j) (2010).

88. See, e.g., *GMAC v. Horne*, 390 B.R. 191, 202–03 (E.D. Va. 2008).

conclude that negative equity is also part of the price of the vehicle under the U.C.C.⁸⁹

The problem with reading these statutes together is that the MVRISA and TILA do not define “purchase money security interest,” which is the term at issue. Instead, the courts look to these other statutes for guidance on the term “price” as used in the U.C.C. In fact, the statutes that the courts look to do not even define the term “price.” The New York Court of Appeals noted that “New York has defined ‘price’ in its Motor Vehicle Retail Installment Sales Act . . . to include negative equity.”⁹⁰ But the New York legislature defined “cash sale price”—as most state RISA statutes do—it did not define “price.”⁹¹

The Eighth Circuit’s reason for reading Missouri’s Motor Vehicle Time Sales Act (MVTSA) in conjunction with Missouri’s U.C.C. is even more questionable. First, the court found that “Article 9 and MVTSA both relate to the installment financing of motor vehicles, and should be read *in pari materia*.”⁹² Yet the Missouri U.C.C. contains no rules regarding installment sales or motor vehicles. The court went on to compare the term “price” in the U.C.C. with the terms “cash sale price” and “time sale price” in the MVTSA. It held that because the Missouri legislature had defined “cash sale price” to mean literally that—the price at which the vehicle would have been sold for cash—and the legislature defined “time sale price” to include “other benefits,” the legislature must have meant to equate price in the U.C.C. with time sale price in the MVTSA.⁹³

The TILA regulations do not use the term “price” either. Instead, they use the terms “amount financed” and “total sale price.”⁹⁴ Indeed, TILA does not even apply to business transactions.⁹⁵ U.C.C. section 9-103 applies to all transactions, and the courts using *in pari materia* to compare TILA and the U.C.C. are defining the term “price” in a statute that applies to businesses and

89. *Id.*

90. *Reiber v. GMAC, LLC (In re Peaslee)*, 913 N.E.2d 387, 390 (N.Y. 2009).

91. N.Y. PERS. PROP. § 301(6) (Consol. Supp. 2009).

92. *Ford Motor Credit Co. v. Mierkowski (In re Mierkowski)*, 580 F.3d 740, 743 (8th Cir. 2009).

93. *Id.*

94. 12 C.F.R. §§ 226.18(b), 226.18(j) (2010). Comparing “price” in the TILA regulations to “price” in the U.C.C. is further complicated by the fact that one is a federal law and the other is a state law. In dissenting from the Tenth Circuit’s opinion, Judge Tymkovich noted that “the manner in which a federal agency has interpreted the term ‘price’ in a federal statute sheds little light on what [a state] legislature meant when it employed the term in its version of the U.C.C.” *Ford v. Ford Motor Credit Corp. (In re Ford)*, 574 F.3d 1279, 1292 (10th Cir. 2009).

95. 15 U.S.C. § 1603(1) (2006). Justice Smith of the New York Court of Appeals expressed his concern that the majority’s interpretation of PMSI to include negative equity would have a detrimental impact on the priority scheme set out by the New York U.C.C. *In re Peaslee*, 913 N.E.2d at 393 (Smith, J., dissenting).

consumers alike using another statute that applies only to consumers.⁹⁶

Even if the U.C.C., TILA, and state RISA statutes all used the exact same term, the U.C.C. has a very different purpose than the TILA and RISA statutes. Statutes should be read *in pari materia* only “when they relate to the same person or thing, to the same class of persons or things, or have the same purpose or object.”⁹⁷ Whether the statutes have the same purpose or object is more important than whether they relate to the same class of persons in determining if they are so closely related that they should be read together.⁹⁸ If the same class of persons is affected by statutes having different purposes, the statutes should not be read *in pari materia*.⁹⁹ The Ninth Circuit employed this rule when it held that it could not read the California Automobile Sales Finance Act (ASFA) together with the U.C.C. because “[t]he disclosure provisions of the ASFA were enacted for a different purpose than the ‘price of the collateral’ provision in the U.C.C.”¹⁰⁰

The purpose of Article 9 of the U.C.C. is to provide rules governing the creation and enforcement of security interests.¹⁰¹ In contrast, the purpose of TILA is to provide consumers with “a meaningful disclosure of credit terms . . . [to prevent] the uninformed use of credit, and to protect the consumer against inaccurate and unfair credit billing . . . practices.”¹⁰² Similarly, the purpose of RISA statutes is to allow consumers to make informed decisions about credit through extensive disclosure.¹⁰³ The goal of

96. Admittedly, the U.C.C. provides that transactions governed by Article 9 may be subject to “any applicable rule of law which establishes a different rule for consumers.” U.C.C. § 9-201(b) (2001). But something as fundamental as the price of a piece of collateral should not be subject to different rules for consumers and for businesses. Courts that read the U.C.C. *in pari materia* with consumer statutes would then allow negative equity to form the basis of a PMSI when a consumer purchases a motor vehicle but not when a business purchases a motor vehicle.

97. 2B SINGER & SINGER, *supra* note 65, § 51:3, at 235–37.

98. *Id.* § 51:3, at 240–41. The definition of *in pari materia* in Black’s Law Dictionary only includes subject matter. The dictionary defines “*in pari materia*” as “[o]n the same subject; relating to the same matter. It is a canon of construction that statutes that are *in pari materia* may be construed together, so that inconsistencies in one statute may be resolved by looking at another statute on the same subject.” BLACK’S LAW DICTIONARY 862 (9th ed. 2009).

99. 2B SINGER & SINGER, *supra* note 65, § 51:3, at 247; *see also* Nashville, Chattanooga & St. Louis Ry. v. Ry. Employees’ Dep’t of Am. Fed’n of Labor, 93 F.2d 340, 343 (6th Cir. 1937) (“[W]e know of no rule of statutory construction which requires two acts relating to separate and distinct subjects to be read *in pari materia*, even though they affect the same general class of persons.”) (emphasis added). For example, the Clayton Act and the Federal Trade Commission Act are not to be read *in pari materia*. *United States v. Papercraft Corp.*, 540 F.2d 131, 138 (3d Cir. 1976).

100. *AmeriCredit Fin. Servs., Inc. v. Penrod (In re Penrod)*, No. 08-60037, 2010 U.S. App. LEXIS 14588, at *12 (9th Cir. July 16, 2010).

101. *See* U.C.C. § 9-101 cmt. 1 (2001).

102. 15 U.S.C. § 1601(a) (2006); *see also In re Loos*, 189 B.R. 495, 497 (Bankr. D. Ariz. 1995) (“The purpose of TILA is to promote the informed use of credit by consumers.”).

103. *See, e.g.*, 69 PA. CONS. STAT. ANN. § 602(d) (West 2004) (“[I]t is hereby declared to be the policy of the Commonwealth of Pennsylvania . . . to [ensure] honest and efficient consumer credit

both TILA and RISA statutes is to protect consumers, whereas the goal of Article 9 of the U.C.C. is to protect the rights of creditors.¹⁰⁴ Moreover, even assuming that the U.C.C. relates to the same subject as TILA and RISA statutes, the *in pari materia* doctrine allows an inference that the legislature's failure to include negative equity in the U.C.C. definition of "price" when it was already included in "cash sale price" in the RISA statute was deliberate.¹⁰⁵ Comparing the U.C.C. to TILA and RISA statutes is like comparing the rules regarding how to make a baseball with the rules regarding how to play the game of baseball. While the two may use the same term, they cover two very different subjects.

2. Value Given to Enable

The circuit courts further suggest that the financing of negative equity is "value given to enable" the debtor to acquire rights in the new car.¹⁰⁶ Without paying off the negative equity on the trade-in, the debtor would not have been able to purchase the car. The Fourth Circuit looked to the dictionary definition of the term "enable," finding that it means "to make possible."¹⁰⁷ The court concluded that the negative equity enabled the purchase of the new vehicle because it was integral to the whole transaction.¹⁰⁸ Car dealers are unwilling to accept a trade-in with a lien still attached, so the negative equity on the trade-in must be extinguished for the transaction on the new car to move forward.¹⁰⁹ The court found that the negative equity enabled the transaction because "it allow[ed] the purchaser to utilize the value of the trade-in."¹¹⁰

service for installment purchasers of motor vehicles . . .").

104. Only one circuit that discussed the *in pari materia* argument has rejected it. The Seventh Circuit held that the Illinois RISA is "a consumer-protection statute, intended to require disclosure of the charges that make up the total price that a consumer pays for the car, rather than to prescribe what is and is not included in the purchase money security interest." *Howard v. AmeriCredit Fin. Servs. (In re Howard)*, 597 F.3d 852, 857 (7th Cir. 2010).

105. 2B SINGER & SINGER, *supra* note 65, § 51:2, at 225–28.

106. *Nuvell Credit Corp. v. Westfall (In re Westfall)*, 599 F.3d 498, 505 (6th Cir. 2010); *In re Howard*, 597 F.3d at 857–58; *Reiber v. GMAC, LLC (In re Peaslee)*, 585 F.3d 53, 57 (2d Cir. 2009); *Dale v. Ford Motor Credit Co. (In re Dale)*, 582 F.3d 568, 575 (5th Cir. 2009); *Wells Fargo Fin. Acceptance v. Price (In re Price)*, 562 F.3d 618, 625 (4th Cir. 2009).

The Ninth Circuit refused to consider this prong of the definition of PMSI, finding that the "value given to enable" prong applied only when the transaction was financed by a third-party lender at the outset. The dealership (which was the seller of the collateral) had initially financed the automobile and sold the loan to AmeriCredit. *AmeriCredit Fin. Servs., Inc. v. Penrod (In re Penrod)*, No. 08-60037, 2010 U.S. App. LEXIS 14588, at *15–16 (9th Cir. July 16, 2010).

107. *In re Price*, 562 F.3d at 625 (internal quotation marks and citation omitted).

108. *Id.*

109. *Id.* Indeed, in some states it is a felony for a car dealer to accept a trade-in without paying off the outstanding loan. *See, e.g., In re Dale*, 582 F.3d at 571 n.3 (citing Texas statute).

110. *In re Price*, 562 F.3d at 627.

Furthermore, courts have found that it would be logistically impossible for the debtor to complete the purchase of the new car without trading in the old one. For example, the *In re Weiser* court placed much emphasis on Lisa's testimony that she would not have qualified for a loan to buy the Pontiac unless she traded in, and paid off the loan on, the RAV4.¹¹¹

The circuit courts have rejected debtors' arguments that the financing of negative equity enabled the transaction, rather than enabled the debtor to acquire rights in the vehicle. In *In re Price*, the Fourth Circuit reasoned that "[i]f negative equity financing enabled the transaction in which the new car was acquired, then, in reality, the negative equity financing also enabled the acquisition of rights in the new car."¹¹² Similarly, the Sixth Circuit in *In re Westfall* found that "[t]he portion attributable to negative equity played an integral role in the overall transaction."¹¹³ The negative equity financing enabled the debtors to acquire rights in the new car because the "[d]ebtors incurred the entire obligation at the same time for the singular purpose of acquiring the new vehicle."¹¹⁴

The circuit courts are reading the U.C.C. much too broadly. While it is true that paying off the loan on the debtor's trade-in car does enable her to buy the new car by freeing up some cash, it does not enable the debtor to buy the new car in the same way that the money for the sticker price of the new car does. The circuit courts reason that the debtor needs to pay off the old car in order to trade it in for the new car, and to do so she needs to pay off the negative equity on the old car.¹¹⁵ While Lisa was financially unable to afford two cars at the same time, she was not *required* to trade in the RAV4 in order to acquire rights in the Pontiac.¹¹⁶ The money the new creditor gives the debtor to pay off the old creditor "is value that enables the debtor to *pay off his or her existing car lender*. It is not value that enables the debtor to buy the new car."¹¹⁷ The value given for the negative equity enables the car dealer to take the trade-in, it does not enable the car dealer to make the sale.

Further, the courts have needlessly confused enabling the transaction with enabling the debtor to acquire rights in the vehicle. According to the Fourth

111. *In re Weiser*, 381 B.R. 263, 268 (Bankr. W.D. Mo. 2007).

112. *Price*, 562 F.3d at 625.

113. *Nuvell Credit Corp. v. Westfall (In re Westfall)*, 599 F.3d 498, 505 (6th Cir. 2010).

114. *Id.*

115. *In re Weiser*, 381 B.R. at 267–68; *see also In re Price*, 562 F.3d at 627 (“[T]ransactions involving items other than automobiles would present very different circumstances from the ones before us here.”).

116. *See Ford v. Ford Motor Credit Corp. (In re Ford)*, 574 F.3d 1279, 1289 (10th Cir. 2009) (Tymkovich, J., dissenting). Judge Tymkovich noted that decisions to finance the negative equity on a trade-in depend on the individual circumstances of each debtor. *Id.*

117. Brief *Amicus Curiae* in Support of Debtors Position Seeking Affirmance in Part at 13, *In re Price*, 562 F.3d 618 (No. 07-2185), 2008 WL 2307405 (emphasis added).

and Tenth Circuits, “[f]rom a practical perspective, that distinction is meaningless.”¹¹⁸ But the distinction is incredibly meaningful, because the U.C.C. allows a PMSI only for “value given to enable the debtor to acquire rights in or the use of the collateral.”¹¹⁹ The U.C.C. does provide that a debtor incurs a purchase money obligation for all expenses that enable the debtor to complete the transaction with the creditor. Courts should be focused on only the expenses that allow the debtor to acquire rights in the new vehicle. Financing negative equity does not allow the debtor to acquire rights in the new vehicle. Negative equity is a value given to the debtor to allow her to trade in her old vehicle before she purchases a new one. The new creditor *must* finance the negative equity only in the sense that someone needs to pay the dealer the negative equity balance so that the dealer can pay the loan on the old vehicle, otherwise the dealer could not take the trade-in.

3. Close Nexus

Comment 3 to section 9-103 of the U.C.C. is also clear that a “close nexus” must exist between the “acquisition of collateral and the secured obligation.”¹²⁰ The circuit courts have invariably held that the new lender’s financing of the negative equity has a sufficiently close nexus with the acquisition of the collateral.¹²¹ They reason that the close nexus requirement is satisfied because all components of the new loan are part of a single transaction memorialized on a single document.¹²² The financing of the negative equity would not take place without the purchase of the new car, so the deal is, in essence, a “package deal.”¹²³ The Tenth Circuit found that the trade-in transaction is essentially a “swap,” and that the additional financing of negative equity “should not turn the swap into two separate transactions.”¹²⁴ According to the Fourth Circuit, the trade-in is a single transaction, and negative equity is simply an expense incurred in the transaction.¹²⁵

This approach favors the form over the substance of the transaction. The debtor did not simply trade one car for another and in the process incur more debt. The new car dealer purchased the old car from the debtor and the debtor

118. *In re Westfall*, 599 F.3d at 505 (quoting *In re Price*, 562 F.3d at 625).

119. U.C.C. § 9-103(a)(2) (2001).

120. U.C.C. § 9-103 cmt. 3.

121. *In re Westfall*, 599 F.3d at 505; *Ford Motor Credit Co. v. Mierkowski* (*In re Mierkowski*), 580 F.3d 740, 743 (8th Cir. 2009); *In re Ford*, 574 F.3d at 1285; *In re Price*, 562 F.3d at 627; *Graupner v. Nuvell Credit Corp.* (*In re Graupner*), 537 F.3d 1295, 1302 (11th Cir. 2008).

122. *In re Westfall*, 599 F.3d at 505; *In re Ford*, 574 F.3d at 1284–85.

123. *Ford Motor Credit Co. v. Mierkowski* (*In re Mierkowski*), 580 F.3d 740, 743 (8th Cir. 2009) (quoting *In re Graupner*, 537 F.3d at 1302); *In re Price*, 562 F.3d at 625 (same).

124. *In re Ford*, 574 F.3d at 1285.

125. *In re Price*, 562 F.3d at 627.

purchased a new car from the dealer, resulting in two separate transactions. It should not matter that the transactions were memorialized in a single contract. In contrast to the other circuits, the Ninth Circuit dismissed the creditor's "package deal" argument, holding that a PMSI does not arise simply because two types of debt are memorialized on a single document.¹²⁶

When the dealer purchased the old car from the debtor, it paid the debtor a certain purchase price. In Lisa's case, Van Chevrolet paid \$21,000 for Lisa's Toyota. It is true that Lisa still owed Toyota Motor Finance \$9,031.64 after the purchase, but Lisa could have paid this remaining balance in any number of ways. For instance, she could have paid cash or she could have paid the balance using her credit card. Instead, she chose to finance that amount with Van Chevrolet at the same time she purchased a new car. That choice does not transform what are essentially two transactions into a single transaction, regardless of whether they are memorialized in a single document.

The majority of the circuit courts seem to disregard the fact that the rolling of negative equity into the new loan is essentially a refinance.¹²⁷ The 2001 revision to the U.C.C. clarified that a PMSI that is refinanced retains its character as a PMSI for non-consumer goods transactions.¹²⁸ Subsection (h) leaves it to the courts to determine whether to apply the same rule for consumer goods.¹²⁹ The comments are clear, however, that if additional funds beyond the original purchase price are loaned in the refinance transaction, the new loan is a PMSI only to the extent of the amount of the original purchase price that was refinanced.¹³⁰

Moreover, negative equity is essentially antecedent debt.¹³¹ Case law construing PMSI in light of § 522(f) of the Bankruptcy Code makes clear that any antecedent debt financed in a purchase money transaction cannot form the basis of a PMSI.¹³² The debtor incurred the obligation to pay before the

126. AmeriCredit Fin. Servs., Inc. v. Penrod (*In re Penrod*), No. 08-60037, 2010 U.S. App. LEXIS 14588, at *10 (9th Cir. July 16, 2010).

127. *In re Penrod*, 2010 U.S. App. LEXIS 14588, at *9 ("[Negative equity] is the payment of an antecedent debt, not an expense incurred in buying the new vehicle."); see also Reiber v. GMAC, LLC (*In re Peaslee*), 913 N.E.2d 387, 391 (N.Y. 2009) (Smith, J., dissenting) ("A refinanced loan is not, in accounting terms, properly speaking, an 'expense' at all; it is the substitution of a new liability for an old one.").

128. U.C.C. § 9-103(f)(3) (2001).

129. *Id.* § 9-103(h). Eight states have chosen to eliminate the consumer/non-consumer goods distinction, see *infra* note 190, so a refinance would not destroy the PMSI for a consumer goods transaction.

130. U.C.C. § 9-103 cmt. 7a. The comment indicates that if the remaining \$10,000 on a PMSI loan were refinanced along with an additional \$2,000, the \$2,000 would not be a PMSI. *Id.*

131. Black's Law Dictionary defines "antecedent" as "preexisting." BLACK'S LAW DICTIONARY, *supra* note 98, at 107.

132. See, e.g., Matthews v. Transamerica Fin. Servs. (*In re Matthews*), 724 F.2d 798, 800-01 (9th Cir. 1984); see also U.C.C. § 9-107 cmt. 2 (1972).

transaction to purchase the new car was entered into, so the negative equity is a preexisting debt. The Eastern District of Michigan concluded in *In re Muldrew* that the negative equity was part of the “bargained-for total cash price of the new vehicle.”¹³³ This conclusion mischaracterizes the negative equity. Even if the price of the new car was higher or lower due to the inclusion of negative equity, the fact is not changed that the debtor had an obligation to pay the negative equity amount before she ever walked into the car dealership. That obligation is not sufficiently related to the new car purchase to satisfy the close nexus requirement.

Further, the vehicle does not secure money required to make the purchase. Judge Bye of the Eighth Circuit noted that when a debtor takes out a general loan and pledges his vehicle as security, the creditor has a security interest in the vehicle, just not a PMSI.¹³⁴ “The close association which financing negative equity has to many vehicle sales transactions is not enough to satisfy the close nexus test, because negative equity is not causally related to the price of the new vehicle.”¹³⁵ Similarly, the Ninth Circuit found that while the financing of negative equity was in fact connected to the purchase of the vehicle, it was not “sufficiently connected” to allow a PMSI.¹³⁶

The circuit courts also place emphasis on the fact that the debtor is trading in an old *car* for a new *car*.¹³⁷ Some even acknowledge that had the debtor asked for funds to pay off her credit cards or go on a vacation, that portion of the loan on the new car would not be purchase money.¹³⁸ But it should not matter that the debtor traded in one type of good for a new one of the same type. What would happen if the debtor traded in a motorcycle? Or an RV? Or a golf cart? Or a bicycle? Those are all vehicles that could serve as the debtor’s primary mode of transportation, but the circuit courts would surely agree that any negative equity in those items that was financed by the new car lender would not be a PMSI.¹³⁹

133. Nuvell Credit Co. v. Muldrew (*In re Muldrew*), 396 B.R. 915, 926 (E.D. Mich. 2008).

134. Ford Motor Credit Co. v. Mierkowski (*In re Mierkowski*), 580 F.3d 740, 744 (8th Cir. 2009) (Bye, J., dissenting).

135. *Id.* at 747.

136. AmeriCredit Fin. Servs., Inc. v. Penrod (*In re Penrod*), No. 08-60037, 2010 U.S. App. LEXIS 14588, at *9 (9th Cir. July 16, 2010).

137. See Ford v. Ford Motor Credit Corp. (*In re Ford*), 574 F.3d 1279, 1285–86 (10th Cir. 2009); Wells Fargo Fin. Acceptance v. Price (*In re Price*), 562 F.3d 618, 627 (4th Cir. 2009).

138. See *In re Ford*, 574 F.3d at 1285–86; *In re Price*, 562 F.3d at 627.

139. One court questioned whether the cost of an emergency appendectomy might be covered as a PMSI under the prevailing PMSI interpretation, assuming that the debtor would not have made it to the car dealer’s lot without it. *In re Westfall*, 365 B.R. 755, 762 (Bankr. N.D. Ohio 2007); see also *In re Ford*, 574 F.3d at 1286 (“An automobile dealer who attempted to refinance unrelated antecedent debt and secure the new debt with the new car would present a question wholly different from the question presented here.”).

The courts are also hung up on the fact that a debtor does not retain possession of the trade-in. In *In re Vega*, the debtors still owed a little over \$2,000 on a Kia when they decided to purchase a Dodge Intrepid.¹⁴⁰ The creditor agreed to roll the remaining \$2,000 into the loan for the Dodge and release its security interest in the Kia, but the debtors kept the Kia.¹⁴¹ The Bankruptcy Court for the District of Kansas refused to accord purchase money status to the \$2,000 the creditor rolled into the new loan because the amount did not make it possible for the debtors to acquire rights in the Intrepid.¹⁴² The Tenth Circuit cited *In re Vega* as an example of unrelated antecedent debt, but it provided no explanation for why the result should be different whether the debtor keeps the old car or gives it to the dealer.¹⁴³ In both circumstances the creditor is extinguishing a preexisting security interest on a vehicle in which it has absolutely no interest.

The Fourth Circuit rejected the notion that debt from a source other than negative equity on a trade-in would ever be present in a car loan.¹⁴⁴ “The Prices present no comparable reason why people would fold their credit card or other debts into the purchase of a car, or why car dealers or lenders would be eager to permit them to do so.”¹⁴⁵ But it is not hard to imagine an eager car dealer wanting to help a debtor qualify for a car loan by paying off her overdue credit card balance. The Fourth Circuit seems to acknowledge that the credit card balance would not be a PMSI without providing any explanation why a balance on the trade-in car is any different than the credit card balance.

The Eleventh Circuit emphasized that its holding extended only to “reasonable, bona fide negative equity in the trade-in vehicle.”¹⁴⁶ The court stated that the result might be different if “there is evidence of subterfuge relating to an unrelated antecedent debt.”¹⁴⁷ The Eleventh Circuit failed to explain, however, what would constitute an “unrelated antecedent debt.”

Let’s imagine that a debtor owned her vehicle free and clear of any liens. She then borrowed money to take a vacation and granted the lender a security interest in the vehicle. A year later the debtor decides to trade in the vehicle

140. *In re Vega*, 344 B.R. 616, 617–18 (Bankr. D. Kan. 2006).

141. *Id.*

142. *Id.* at 623.

143. *In re Ford*, 574 F.3d at 1286; see also *In re Myers*, 393 B.R. 616, 622 (Bankr. S.D. Ind. 2008) (“Had the Debtor here kept the Jeep Wrangler, the Court would have reached a different result, for the part of the loan that was used to pay off the Jeep Wrangler did *not* enable the Debtor to acquire rights in the Caliber, it merely paid off an existing debt on the Wrangler.”)

144. *Wells Fargo Fin. Acceptance v. Price (In re Price)*, 562 F.3d 618, 627 (4th Cir. 2009).

145. *Id.*

146. *Graupner v. Nuvell Credit Corp. (In re Graupner)*, 537 F.3d 1295, 1303 n.5 (11th Cir. 2008).

147. *Id.*

for a new one, but the debtor owes more on the vacation loan than the value of her car. The dealership agrees to allow the debtor to wrap the negative equity into her new loan. The question is whether the circuit courts would agree that the negative equity in this case—from an entirely unrelated loan used to take a vacation—is not purchase money. The Eleventh Circuit’s statement seems to indicate that the court would not consider the negative equity in that situation to be purchase money. So why do the courts consider negative equity from loans like the one in Lisa’s case to be purchase money and thus closely related to the purchase of the new collateral? Negative equity does not have a “close nexus” to the purchase of a new car simply because the negative equity originated from the purchase of another car.

4. Commercial Practices

Finally, many of the circuit courts reason that allowing negative equity to be a PMSI accords with the goals of the U.C.C.¹⁴⁸ Section 1-103 states that the U.C.C. “must be liberally construed . . . to promote its underlying purposes and policies, which [include] . . . [permitting] the continued expansion of commercial practices through custom, usage, and agreement of the parties.”¹⁴⁹ The financing of negative equity in new car purchase transactions has become commonplace,¹⁵⁰ but it is not necessarily a practice that should be promoted and encouraged.¹⁵¹ The bankruptcy court in *In re Pajot* suggested that the inclusion of negative equity in a new car loan is imprudent borrowing and imprudent lending.¹⁵² And Judge Bye of the Eighth Circuit noted that commercial practices cannot change the character of the negative equity debt: “Negative equity is an antecedent unsecured debt and cannot be transformed into a purchase money obligation secured by a PMSI by rolling it into the loan [for the vehicle].”¹⁵³ Moreover, the drafters of the 2001 revision to the U.C.C. were likely aware of the practice and deliberately chose not to include negative equity in the list of examples in Comment 3 to section 9-103.¹⁵⁴

148. *Howard v. AmeriCredit Fin. Servs. (In re Howard)*, 597 F.3d 852, 857–58 (7th Cir. 2010); *Reiber v. GMAC, LLC (In re Peaslee)*, 585 F.3d 53, 57 (2d Cir. 2009); *In re Price*, 562 F.3d at 627–28.

149. U.C.C. § 1-103(a) (2001).

150. One study found that nearly 40% of all new car buyers have negative equity on their trade-in. Danny Hakim, *Owing More on an Auto than It’s Worth as a Trade-In*, N.Y. TIMES, Mar. 27, 2004, at C1.

151. See *In re Pajot*, 371 B.R. 139, 165 (Bankr. E.D. Va. 2007). Chief Judge Tice also suggested that such unsound financial practices contribute to the reasons that debtors end up in his courtroom. *Id.*

152. *Id.*

153. *Ford Motor Credit Co. v. Mierkowski (In re Mierkowski)*, 580 F.3d 740, 746 (8th Cir. 2009) (Bye, J., dissenting).

154. In 2001, approximately one in four new car buyers had negative equity on their trade-in.

B. Congressional Intent

Though unnecessary, the circuit courts have often looked to congressional intent to discern the meaning of “purchase money security interest.” With regard to the hanging paragraph, there is no doubt that “Congress was attempting to remedy a perceived abuse by those who buy vehicles on credit on the eve of bankruptcy and then utilize the cramdown provisions of the Bankruptcy Code to pay the secured creditor a lesser amount than its full claim.”¹⁵⁵ Thus, the court in *In re Petrocci* concluded that the “primary purpose” of the hanging paragraph is to disallow bifurcation of unsecured negative equity debt, requiring the car creditor to be “paid in full to the detriment of other unsecured creditors.”¹⁵⁶

But looking to federal congressional intent in enacting the hanging paragraph ignores several important issues. First, by using a term defined in the U.C.C., Congress cannot alter the meaning of the term without providing a specific definition of the term in the Bankruptcy Code. Second, the hanging paragraph represents a compromise between car creditors and credit card creditors because the new “means test” would force more consumer debtors into Chapter 13 instead of Chapter 7 bankruptcy, which is more favorable for car creditors. Third, the hanging paragraph protects the unique position of the car lender, whose collateral rapidly depreciates the moment the debtor takes possession. Finally, such a liberal reading of the hanging paragraph is not compatible with fundamental bankruptcy policy.

1. Congress Cannot Alter the Meaning of PMSI

First and foremost, federal legislative history seems largely irrelevant to the negative equity question. As I noted above, a PMSI is a property right that is defined by state law—and state law alone—unless Congress alters it.¹⁵⁷ The plain language of the hanging paragraph suggests that those attempting to interpret the meaning of “purchase money security interest” should proceed directly to state law because Congress provided no separate definition for the term in the Bankruptcy Code. Congress used a term that already had a defined meaning outside the Bankruptcy Code, and, more importantly, that term involves a specific property interest, which is almost always a matter of state law. Thus, courts should be interpreting the phrase as a matter of state law—congressional intent regarding the phrase is irrelevant, unless Congress meant to redefine the scope of a PMSI.

The circuit courts looking to congressional intent have concluded that

See Hakim, *supra* note 150.

155. *In re Payne*, 347 B.R. 278, 281 (Bankr. S.D. Ohio 2006).

156. *In re Petrocci*, 370 B.R. 489, 502 (Bankr. N.D.N.Y. 2007).

157. *See supra* Part II.C.

Congress intended that PMSI have a broad meaning in the hanging paragraph. They arrive at this conclusion by noting that the section of the BAPCPA that includes the hanging paragraph is titled “Giving Secured Creditors Fair Treatment in Chapter 13.”¹⁵⁸ In addition, the subsection containing the language for the hanging paragraph begins with the phrase “Restoring the Foundation for Secured Credit.”¹⁵⁹ Because of the new protections offered by the hanging paragraph, the courts reason that Congress could have meant only good things for creditors.¹⁶⁰ While Congress may have intended only good things for creditors, congressional intent did not explicitly expand the definition of PMSI beyond the state law meaning of the term.¹⁶¹

To date, no court has attempted to discern the intent of the U.C.C. drafters regarding the breadth of a PMSI. Furthermore, none have attempted to examine state legislative history. If the scope of PMSI is murky enough to examine legislative history, courts should be examining state legislative history (and U.C.C. drafting history), not federal legislative history. Federal legislative history could be used to discern whether Congress intended to follow the state law rule for PMSI or create a federal rule. But it is hard to understand why the circuit courts rely on the U.C.C. and state law in concluding that negative equity can be part of a PMSI while at the same time concluding that the result is supported by federal legislative history.

2. The Hanging Paragraph Compromise

The most fundamental change in existing bankruptcy policy introduced by the BAPCPA was the “means test” for Chapter 7 debtors.¹⁶² The vast majority of consumer debtors will choose between Chapter 7 and Chapter 13 bankruptcy. In Chapter 7 bankruptcy, a debtor without significant assets can have most of his debts discharged and come out of bankruptcy relatively unscathed within six to nine months. In Chapter 13, however, the debtor must pay a portion of his income to his creditors every month for either three or

158. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 306, 119 Stat. 23, 80.

159. *Id.* § 306(b).

160. Graupner v. Nuvel Credit Corp. (*In re Graupner*), 537 F.3d 1295, 1303 (11th Cir. 2008). The courts must make inferences regarding Congress’s intent because the legislative history regarding the hanging paragraph is sparse. See *In re Hayes*, 376 B.R. 655 add. at 676–84 (Bankr. M.D. Tenn. 2007), for a complete legislative history of the paragraph. Judge Lundin’s overview includes several versions of the hanging paragraph, but the legislative history does not include any committee reports or other policy statements that would allow any insight into Congress’s motivations. *But see* William C. Whitford, *A History of the Automobile Lender Provisions of BAPCPA*, 2007 U. ILL. L. REV. 143.

161. Ford Motor Credit Co. v. Mierkowski (*In re Mierkowski*), 580 F.3d 740, 747 (8th Cir. 2009) (Bye, J., dissenting).

162. See 11 U.S.C. § 707(b) (2006); Charles J. Tabb & Jillian K. McClelland, *Living with the Means Test*, 31 S. ILL. U. L.J. 463, 505 (2007).

five years. The means test forces debtors with the ability to sustain a payment plan into Chapter 13. The credit card creditors and other unsecured creditors obtain a better return in a Chapter 13 bankruptcy because at least a portion of the debt will be repaid through the life of the Chapter 13 plan.

Car creditors did not fare as well in Chapter 13 before BAPCPA. If a Chapter 7 debtor wants to retain possession of a car that is not paid off, he has three options: (1) redeem the car by paying the full amount due on the loan; (2) surrender the car, which would allow the creditor to sell the car, apply the proceeds to the outstanding balance, and file an unsecured claim for the remainder; or (3) reaffirm the debt.¹⁶³ Most debtors are unable to redeem the car by paying in full (else why would they be in Chapter 7?), nor do they want to surrender their car to the creditor to pay the debt, so most debtors sign a reaffirmation agreement. The reaffirmation agreement commonly provides that the debtor will repay the entire amount owing, with interest, so the car creditor emerges from the debtor's bankruptcy in relatively the same position it was in prior to the bankruptcy.¹⁶⁴ In contrast, prior to BAPCPA, the Chapter 13 car creditor could expect to take a big hit due to the debtor's ability to cram down the loan.¹⁶⁵ The creditor would receive the market value of the collateral plus pennies on the dollar for the remaining unsecured deficiency.¹⁶⁶

Because the means test was going to force many more potential Chapter 7 debtors into Chapter 13, the car creditors could expect to lose a lot of money on crammed-down loans.¹⁶⁷ At the behest of the car creditors, Senator Spencer Abraham from Michigan introduced the hanging paragraph during a meeting of the Senate Judiciary Committee.¹⁶⁸

Surprisingly, the amendment prompted little public criticism from credit card issuers or other large groups of unsecured creditors.¹⁶⁹ The credit card

163. 11 U.S.C. § 521(a)(2). Prior to BAPCPA, the debtor had a fourth option: do nothing. If the debtor was current on her payments, the car loan would quietly "ride-through" the bankruptcy without change. Braucher, *supra* note 33, at 475–77. The ride-through option was rejected by many courts, however, and some creditors did not like it because, while the creditor retained a lien on the vehicle, the debtor's personal obligation to pay was discharged in the bankruptcy. Whitford, *supra* note 160, at 148–49. The continued validity of this fourth option after BAPCPA remains to be seen. See Christopher M. Hogan, Note, *Will the Ride-Through Ride Again?*, 108 COLUM. L. REV. 882, 925–26 (2008) (arguing that the ride-through should continue as a viable option post-BAPCPA).

164. Whitford, *supra* note 160, at 144–46. The car creditor has superior bargaining power in negotiating reaffirmation agreements because the debtor will not be able to easily replace her car if she surrenders it to the car creditor due to her impaired credit rating. *Id.* at 145.

165. *Id.* at 145–46.

166. *Id.*

167. *Id.* at 146.

168. *Id.* at 177. Though many expected some sort of protection for car creditors in Chapter 13, the amendment was not circulated before the meeting and was introduced as a surprise. *Id.* at 178.

169. *Id.* at 178–79.

issuers must have realized that they would not be able to force so many more debtors into Chapter 13 without giving some sort of consolation to car creditors. The hanging paragraph must be seen for what it is—a compromise between car creditors and unsecured creditors. Increasing the amount of a secured debt that a debtor must pay through her Chapter 13 plan means that less of the debtor’s funds will be available to pay unsecured creditors through the plan. If the unsecured creditors had known that the car creditors would use the hanging paragraph to substantially increase the amount of their secured claims (by almost 50% in Lisa Weiser’s case), they might have fought harder to clarify the narrow meaning of “purchase money security interest.”

In his dissent from the Tenth Circuit’s opinion, Judge Tymkovich noted that “purchase money security interest” did not appear in early versions of the hanging paragraph.¹⁷⁰ One early bill would have protected only the “unpaid balance of the *purchase price*” from cramdown, while another would have protected “an *allowed claim* that is secured under applicable non-bankruptcy law.”¹⁷¹ The former would protect only the sticker price of the car, and the latter would protect the car creditor’s entire claim, including negative equity. The language that Congress ultimately settled on represents a compromise and suggests that Congress did not intend to protect from cramdown every dollar of a car creditor’s claim.

The Fourth Circuit worried that excluding negative equity from the car creditors’ secured claims “would nullify the treatment that Congress intended for a large percentage of vehicle debts.”¹⁷² But the court misconstrued the effect of holding that negative equity cannot form the basis of a PMSI. Even if negative equity is not a PMSI, the creditor still has a PMSI for the rest of the purchase price. Only the negative equity portion will be “stripped” off of the lien. Congress’s intent in protecting car creditors will still be realized by protecting their interest to the extent of the purchase price of the car.¹⁷³

3. The Unique Position of Car Creditors

Car lenders are unique among secured creditors. Their collateral decreases in value significantly the moment the borrower takes possession.¹⁷⁴

170. See *Ford v. Ford Motor Credit Corp. (In re Ford)*, 574 F.3d 1279, 1293–94 (10th Cir. 2009) (Tymkovich, J., dissenting).

171. *Id.* at 1293 (internal quotation marks and citations omitted).

172. *Wells Fargo Fin. Acceptance v. Price (In re Price)*, 562 F.3d 618, 628 (4th Cir. 2009).

173. Judge Tymkovich indicated that use of the term “purchase money security interest” “might have reflected a Congressional compromise to protect certain fees that are properly considered part of a purchase-money loan—i.e., fees akin to transaction costs—and not to protect negative equity.” *In re Ford*, 574 F.3d at 1293–94.

174. See William C. Wood, *The Cost of Driving a Car Off the Dealer’s Lot*, 28 J. CONSUMER AFF. 130, 130 (1994). Wood notes that a car’s value can decrease by as much as 25% as soon as the buyer takes possession. *Id.*

Prior to BAPCPA, a debtor could buy a brand-new car one day and file bankruptcy the next. The debtor then would be able to cram down the car loan to the value of the car and realize thousands of dollars in savings on the loan. Congress enacted the hanging paragraph to prevent this sort of “abuse[] created by spendthrift debtors.”¹⁷⁵ But there is a big difference between a “normal” car loan and one that includes negative equity in the financing: the car financed with a loan that includes negative equity is “underwater” even before the borrower drives it off the lot. In Lisa’s case, the Pontiac’s sticker price was around \$14,000, but it carried a debt of over \$26,000 before she even drove away with it.¹⁷⁶ Certainly Congress could not have meant to protect a lender that is undersecured *before* the buyer takes possession.

A provision similar to the hanging paragraph prohibits modification of a mortgage on the debtor’s principal residence.¹⁷⁷ As a result of the recent downturn in housing prices, many homes are now worth less than the mortgages they secure.¹⁷⁸ In light of the situation, several members of Congress proposed bills that would allow homeowners in Chapter 13 to cram down their home mortgages to the value of the home.¹⁷⁹ As of this writing, the mortgage industry has been successful in its opposition to these bills. But the fact that many members of Congress are sympathetic to these underwater home mortgages signifies that Congress did not intend *only* good things for creditors.

Unlike mortgage creditors, car creditors expect their collateral to depreciate rather than appreciate. Car creditors do not extend a loan that includes negative equity expecting that the automobile will appreciate in value and the creditor will become fully secured. Rather, the value of the automobile is expected to depreciate over the life of the loan. While the creditor does technically have a security interest for the entire amount of the

175. *Gen. Motors Acceptance Corp. v. Peaslee*, 373 B.R. 252, 261 (W.D.N.Y. 2007).

176. Admittedly, the potential for abuse still exists if negative equity is not a PMSI and thus not protected by the hanging paragraph. Under my approach to negative equity, Lisa could have discharged as unsecured debt over \$9,000 of negative equity if she filed bankruptcy the day after she purchased the Pontiac. By crying “abuse,” however, the creditors escape liability for making such a bad loan. The car dealer financed such a large amount of negative equity that it represented over 70% of the Pontiac’s value. Creditors making such risky loans should not be protected by placing the blame on the debtors. If Community America had repossessed the Pontiac, and sued Lisa for the deficiency before Lisa filed for bankruptcy, all of that negative equity would be an unsecured (and therefore dischargeable) claim.

177. 11 U.S.C. § 1322(b)(2) (2006).

178. David Roeder & Francine Knowles, *Read 'em—and Weep: Collapse in Housing Market Leaves Many Who Bought in Last 2 Years Owning More Than Property Worth*, CHI. SUN TIMES, Aug. 12, 2008, at 2 (noting that by 2008, 37.8% of Chicago-area homeowners who purchased homes in 2006 owed more than their homes were worth).

179. Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009); Helping Families Save Their Homes Act of 2009, H.R. 1106, 111th Cong. (2009); Helping Families Save Their Homes in Bankruptcy Act of 2008, S. 2136, 110th Cong. (2007).

loan, the creditor is rarely fully secured. For most of the life of the loan, the balance due on the loan will be more than the value of the collateral.

This is a risky position for the car creditor. If the debtor defaults without filing bankruptcy, the creditor will not be paid in full after foreclosing on its collateral and must turn to the debtor—who has already defaulted—for payment of the unsecured deficiency amount. When the creditor cannot collect the deficiency, it is forced to write off the bad debt. The precarious position of the car creditor is only enhanced by inclusion of negative equity in a car loan.

4. Bankruptcy Policy

The PMSI interpretation of the hanging paragraph is not compatible with bankruptcy policy. Bankruptcy proceedings serve two purposes: they provide troubled debtors with a “fresh start,” and they treat all similarly situated creditors equally when distributing a bankrupt’s assets.¹⁸⁰

In a Chapter 13 bankruptcy, debtors can pay off their secured debt, pay a percentage of their unsecured debt, and have most of the remaining debts discharged. If Chapter 13 debtors are required to pay the full amount due on their car loans, including the negative equity, they will be prevented from obtaining the fresh start that a bankruptcy filing is supposed to give them.¹⁸¹ Instead, a monthly car payment that includes the negative equity balance may be so high that the debtor is forced to surrender the car. The Fourth Circuit asserted that any argument that Chapter 13 debtors would be forced to surrender their cars if they cannot bifurcate the negative equity is “necessarily speculative.”¹⁸² Nevertheless, after Judge Federman ruled that the over \$9,000 in negative equity had to be paid through her Chapter 13 plan, Lisa Weiser was forced to surrender her car.¹⁸³

180. See HENRY CAMPBELL BLACK, A TREATISE ON THE LAW AND PRACTICE OF BANKRUPTCY UNDER THE ACT OF CONGRESS OF 1898 AND ITS AMENDMENTS § 3, at 7 (The Lawbook Exchange 3d ed. 2006) (1922); see also DAVID G. EPSTEIN ET AL., BANKRUPTCY (INCLUDING BAPCPA): 21ST CENTURY DEBTOR-CREDITOR LAW 41-42 (2d ed. 2006).

181. The phrase “fresh start” does not appear in the bankruptcy code; “[c]ourts and commentators however consistently connect the bankruptcy ‘fresh start’ policy with the bankruptcy discharge.” EPSTEIN ET AL., *supra* note 180, at 42; see also *Grogan v. Garner*, 498 U.S. 279, 286-87 (1991) (noting that the policy behind bankruptcy is to provide a “fresh start” for the “honest but unfortunate debtor”) (internal quotation marks and citation omitted).

182. *Wells Fargo Fin. Acceptance v. Price (In re Price)*, 562 F.3d 618, 629 (4th Cir. 2009). To be fair, the car creditors have their own parade of horrors, arguing that not including negative equity in PMSI will make it harder for consumers to buy cars because lenders will be resistant to financing negative equity. *Id.*

183. *In re Weiser*, 381 B.R. 263, 265 (Bankr. W.D. Mo. 2007); Amendment to Chapter 13 Plan at 1, *In re Weiser*, 381 B.R. 263 (No. 07-40714). An issue outside the scope of this Comment is whether Community America would then receive an unsecured claim in the bankruptcy for the deficiency amount after it sold the RAV4 and applied the proceeds to the remaining balance. There is a split in the circuits on this issue, but the Eighth Circuit has ruled that the creditor is allowed to file an unsecured claim for the deficiency. *AmeriCredit Fin. Servs. v. Moore*, 517 F.3d 987, 989

In addition, debtors that cannot afford the higher monthly payment as a result of the inclusion of negative equity may choose to convert to a Chapter 7 liquidation. Many debtors that may otherwise qualify to file for Chapter 7 bankruptcy under BAPCPA's means test file Chapter 13 instead in an effort to save their house or car.¹⁸⁴ This means that unsecured creditors that may have received a small distribution through a Chapter 13 will likely receive nothing if the debtor files bankruptcy under Chapter 7.

Furthermore, "bankruptcy law is not designed to fundamentally alter property rights. Instead, 'a bankruptcy proceeding is principally a forum in which all of a debtor's creditors can gather, assemble the debtor's assets, and divide them among themselves.'"¹⁸⁵ Allowing lenders to recover their full claim for negative equity using the hanging paragraph will favor the car lender over other unsecured creditors. The original purpose of the cramdown provisions of § 506(a) was to allow debt that was essentially unsecured to be treated that way. A secured creditor whose collateral is worth less than the outstanding amount owed is really an unsecured creditor with regard to the deficiency. The hanging paragraph acts against this bankruptcy policy to allow car creditors to recover what would be unsecured debt in a foreclosure proceeding.¹⁸⁶ A Chapter 13 debtor only has so much income. In most cases unsecured creditors will receive a very small distribution in the proceedings. By allowing the car creditor to assert a much larger secured claim than it would otherwise receive, the other creditors are swindled out of their meager distributions. The car creditor should not receive a greater distribution than other unsecured creditors on what is essentially an unsecured claim.

IV. ADDITIONAL CONSIDERATIONS IN THE NEGATIVE EQUITY DEBATE

A. *Dual Status vs. Transformation Rule*

The bankruptcy courts that adopted the non-PMSI interpretation of

(8th Cir. 2008); *Capital One Auto Fin. v. Osborn*, 515 F.3d 817, 822–23 (8th Cir. 2008). Lisa's Chapter 13 plan provided for a zero percent dividend to unsecured creditors, so even though Community America was allowed an unsecured claim in Lisa's bankruptcy after surrender and sale, the bank received nothing on the unsecured deficiency amount. The bank therefore recovered much less than it would have if Lisa had been allowed to cram down the car loan to the sticker price she paid for the Pontiac and pay Community America's secured claim through her Chapter 13 plan.

184. See Susan L. DeJarnatt, *Once Is Not Enough: Preserving Consumers' Rights to Bankruptcy Protection*, 74 IND. L.J. 455, 459–60 (1999).

185. *Ford v. Ford Motor Credit Corp. (In re Ford)*, 574 F.3d 1279, 1286 (10th Cir. 2009) (Tymkovich, J., dissenting) (citation omitted). See also *Bailey v. Glover*, 88 U.S. 342, 346 (1874) (noting that the most important purpose of bankruptcy is equality of distribution).

186. To be sure, the car creditor that finances negative equity and takes a security interest has that security interest until the debtor pays the last dime of her obligation to the creditor. But when a creditor is undersecured and the debtor defaults, which is essentially the result in bankruptcy, the undersecured creditor is left with debt that is unsecured after the value of the collateral is applied to reduce the debt.

negative equity are split as to the effect of the presence of the non-PMSI negative equity portion in the loan. The first group adopts the “dual status” rule, holding that the negative equity portion of the financing is not a PMSI and is not protected by the hanging paragraph, but the remainder of the amount due the car lender is purchase money.¹⁸⁷ The second adopts the “transformation” rule, holding that the presence of a non-purchase money component transforms the entire balance into a non-PMSI.¹⁸⁸

The U.C.C. provides some guidance on the issue, but only for non-consumer goods transactions. Section 9-103(f) provides that “a purchase-money security interest does not lose its status as such, even if the purchase-money collateral also secures an obligation that is not a purchase-money obligation.” For consumer goods transactions, the U.C.C. directs the courts to determine the proper rules.¹⁸⁹ Eight states have opted to eliminate the consumer/non-consumer goods distinction in the U.C.C., applying the dual status rule to all transactions.¹⁹⁰

If the dual status rule is applied, the portion of the debt that originally qualified as a PMSI, i.e., the portion that represents the purchase price for the new car, remains as a PMSI to the extent of the purchase price of the collateral (along with the enumerated expenses in Comment 3).¹⁹¹ The portion of the debt representing the PMSI is subject to the provisions of the hanging paragraph.¹⁹² In Lisa’s case above, \$19,219.60 would represent the PMSI subject to the provisions of the hanging paragraph.¹⁹³ The negative equity of \$9,031.64

187. See, e.g., *Americredit Fin. Servs., Inc. v. Penrod* (*In re Penrod*), 392 B.R. 835, 860 (B.A.P. 9th Cir. 2008), *aff’d* by *AmeriCredit Fin. Servs., Inc. v. Penrod* (*In re Penrod*), No. 08-60037, 2010 U.S. App. LEXIS 14588 (9th Cir. July 16, 2010) (circuit court did not reach the dual status question); *Nuvell Credit Co. v. Callicott* (*In re Callicott*), 396 B.R. 506, 510 (E.D. Mo. 2008); *Citifinancial Auto v. Hernandez-Simpson*, 369 B.R. 36, 48 (D. Kan. 2007); *In re Crawford*, 397 B.R. 461, 468 (Bankr. E.D. Wis. 2008); *In re Johnson*, 380 B.R. 236, 250 (Bankr. D. Or. 2007); *In re Hayes*, 376 B.R. 655, 676 (Bankr. M.D. Tenn. 2007); *In re Pajot*, 371 B.R. 139, 165 (Bankr. E.D. Va. 2007); *In re Acaya*, 369 B.R. 564, 571 (Bankr. N.D. Cal. 2007); *In re Vega*, 344 B.R. 616, 623 (Bankr. D. Kan. 2006).

188. See, e.g., *In re Mitchell*, 379 B.R. 131, 142 (Bankr. M.D. Tenn. 2007); *In re Blakeslee*, 377 B.R. 724, 731 (Bankr. M.D. Fla. 2007); *In re Hunt*, No. 07-20627, 2007 Bankr. LEXIS 2709, at *7 (Bankr. D. Kan. Aug. 14, 2007); *In re Price*, 363 B.R. 734, 746 (Bankr. E.D.N.C. 2007).

189. U.C.C. § 9-103(h) (2001).

190. FLA. STAT. ANN. § 679.1031(6) (West 2003); IDAHO CODE ANN. § 28-9-103(f) (2001); IND. CODE ANN. § 26-1-9.1-103(f) (LexisNexis 2005); KAN. STAT. ANN. § 84-9-103(f) (Supp. 2008); MD. CODE ANN., COM. LAW. § 9-103(f) (LexisNexis 2002); NEB. REV. STAT. § 9-103(f) (2001); N.D. CENT. CODE § 41-09-03(6) (Supp. 2009); S.D. CODIFIED LAWS § 57A-9-103(f) (2004). These statutes eliminate the phrase “other than a consumer-goods transaction” appearing in sections 9-103(e), (f), and (g), as well as the consumer goods caveat in section 9-103(h).

191. *In re Acaya*, 369 B.R. at 570.

192. *Id.* at 571.

193. Community America’s claim of \$28,251.24 minus \$9,031.64 for the negative equity. Under Comment 3 to U.C.C. section 9-103, the interest charges and costs of collection are a PMSI.

would be an unsecured claim paid pro rata with the other unsecured claims.

If the transformation rule is applied, the entire amount financed becomes a non-PMSI.¹⁹⁴ Therefore, it does not meet the requirements of the hanging paragraph and it would be subject to cramdown under § 506(a). In Lisa's case, the Pontiac would be subject to valuation; Community America would receive a secured claim for the market value of the Pontiac at the time of the filing of the bankruptcy petition; and the remainder of the claim would be unsecured.

At least one court proposed to exempt a claim including negative equity from the provisions of the hanging paragraph.¹⁹⁵ The theory is that the hanging paragraph only applies when the *entire* claim is a PMSI.¹⁹⁶ The hanging paragraph provides that § 506(a) does not apply "if" the claim is a PMSI, not "to the extent that" the claim is a PMSI.¹⁹⁷ If Congress meant to allow the hanging paragraph to apply to only part of a claim, it would have used the phrase "to the extent that" because that phrase is used in a number of other places in the Bankruptcy Code.¹⁹⁸ This approach would eviscerate the hanging paragraph because so many car purchases include negative equity. The best approach, and the one I advocate below, is to apply the hanging paragraph to the purchase money portion of the creditor's claim.

I believe the dual status rule, rather than the transformation rule, best harmonizes Congress's intent in enacting the hanging paragraph and the actual status of the creditor's security interest. If Lisa had simply surrendered the Pontiac, instead of filing bankruptcy, Community America would have had an unsecured claim for the negative equity and any other deficiency amount owed above the fair market value of the car.¹⁹⁹ The hanging paragraph was enacted to prevent perceived abuses by debtors that purchased new cars and then filed bankruptcy only a short time later; and in doing so, it leaves the motor vehicle creditor in a somewhat better position than it would be outside of bankruptcy. The transformation rule destroys any effect of the hanging paragraph, which almost certainly defies congressional intent.

The dual status rule is also supported in the text of the U.C.C. Section 9-103(b)(1) provides that "a security interest in goods is a purchase-money security interest to the extent that the goods are purchase-money collateral with respect to that security interest."²⁰⁰ Though Congress did not use the phrase "to the extent that" in the hanging paragraph, it is in the U.C.C.

U.C.C. § 9-103 cmt. 3 (2001).

194. *In re Price*, 363 B.R. 734, 745 (Bankr. E.D.N.C. 2007).

195. *See In re Sanders*, 377 B.R. 836, 860 (Bankr. W.D. Tex. 2007).

196. *Id.*

197. *Id.* at 859–60.

198. *Id.* at 860.

199. *See AmeriCredit Fin. Servs. v. Moore*, 517 F.3d. 987, 989 (8th Cir. 2008).

200. U.C.C. § 9-103(b)(1) (2001).

The use of the phrase suggests that a creditor can have a PMSI and another security interest in the same collateral. The PMSI extends only as far as the purchase money component of the security interest. Any further funds secured by the collateral are not purchase money.

Further, revised Article 9 adopts the dual status rule for non-consumer goods. Section 9-103(f)(1) provides that “in a transaction other than a consumer-goods transaction, a purchase-money security interest does not lose its status as such, even if the purchase-money collateral also secures an obligation that is not a purchase-money obligation.”²⁰¹ The U.C.C. leaves to courts the determination of whether to apply the dual status or transformation rule in consumer goods transactions.²⁰² When they enacted revised Article 9, several states explicitly adopted the dual status rule for consumer goods transactions as well as non-consumer goods transactions.²⁰³

A bright line dual status rule also best aligns with the realities of a bankruptcy practice. Some courts have suggested that, in accordance with the suggestion of section 9-103(h) of the U.C.C., the court should have the discretion in each case to determine whether the dual status or transformation rules should apply.²⁰⁴ But a rule that allows discretion is an invitation to litigation in a forum where the parties can hardly afford to be there in the first place, much less litigate over which rule to apply.

The Seventh Circuit indicated that the hanging paragraph eliminated what was, before BAPCPA, a valuation problem for car creditors.²⁰⁵ The bankruptcy court no longer has to attempt to value the creditor’s collateral by simply providing that the entire claim is secured as long as it is a PMSI. The Seventh Circuit expressed concern that excluding negative equity from the reach of the hanging paragraph would restore the previous valuation problems.²⁰⁶ Yet with the dual status rule, the valuation problem is still cured. The creditor has a PMSI (not subject to cramdown) for the full purchase price of the car. It is only the negative equity that would be crammed down—the creditor’s secured claim still is likely to far exceed the actual value of the car.²⁰⁷

201. U.C.C. § 9-103(f)(1).

202. U.C.C. § 9-103(h).

203. *See supra* note 190.

204. *In re Pajot*, 371 B.R. 139, 157–58 (Bankr. E.D. Va. 2007).

205. *Howard v. AmeriCredit Fin. Servs. (In re Howard)*, 597 F.3d 852, 854 (7th Cir. 2010). Section 506(a)(2) provides that the court determines the replacement value of the car when § 506 is used to bifurcate the loan into secured and unsecured components. 11 U.S.C. § 506(a)(2) (2006). If the court values the car too low, the creditor is worse off because its claim is undervalued. If the court values the car too high, the debtor might be encouraged to surrender the car instead of paying an amount that exceeds the car’s value. *In re Howard*, 597 F.3d at 854.

206. *In re Howard*, 597 F.3d at 858.

207. The Seventh Circuit noted that had the negative equity been stripped from the creditor’s

B. Payment Application Considerations

After determining that the negative equity portion of the loan is not a PMSI, the courts next face the arduous process of determining the *amount* of the secured claim that is protected by the hanging paragraph.²⁰⁸ The court cannot simply subtract the negative equity from the amount of the loan because the debtor will likely have made payments on the loan between the financing date and the petition date.²⁰⁹ The U.C.C. indicates a default rule for application of payments.²¹⁰ Payments should be applied according to the contract between the parties, but, in the absence of a previous agreement, payments should be applied first to the portion of the loan secured by a PMSI.²¹¹

Although most states have a standard motor vehicle retail installment sale contract, it is possible that the agreement between the parties could contain any number of instructions for payment allocation. At least one court has indicated that in the absence of a clear contract indicating the amount of negative equity and the application of payments, it would apply the transformation rule instead of the dual status rule.²¹² This approach would be unwise and certainly would not fulfill Congress's intent in enacting the hanging paragraph. Therefore, the bankruptcy courts should not adopt either a default or discretionary rule, but simply follow the instructions given in the U.C.C.²¹³

V. CONCLUSION

The majority of the circuit courts holding that negative equity can be a

PMSI, AmeriCredit would still have a claim of about \$27,000 on a car that was worth approximately \$24,000. *Id.*

208. *See, e.g., In re Conyers*, 379 B.R. 576, 583 (Bankr. M.D.N.C. 2007).

209. A related issue is how to allocate the PMSI when negative equity has been financed many times over. The *Los Angeles Times* reported the story of one couple that had traded in their cars and refinanced negative equity five times in the previous three years. Ken Bensinger, *New Cars that Are Fully Loaded—With Debt*, L.A. TIMES, Dec. 30, 2007, at A1.

210. U.C.C. § 9-103(e)(3)(B) (2001).

211. *Id.*; *see also Ford v. Ford Motor Credit Corp. (In re Ford)*, 574 F.3d 1279, 1290 (10th Cir. 2009) (Tymkovich, J., dissenting) (advocating that courts simply use the default rules set out in the U.C.C. for payment application questions).

212. *In re Pajot*, 371 B.R. 139, 157–58 (Bankr. E.D. Va. 2007); *see also Dienna Ching, Does Negative Equity Negate the Hanging Paragraph?*, 16 AM. BANKR. INST. L. REV. 463, 507–10 (2008). Ching argues that the transformation rule should be the default rule in the absence of carefully drafted contract language that carves out the negative equity portion of the debt and specifically provides for payment allocation. *Id.*

213. A related issue may arise when the market value of the car on the date of filing exceeds the purchase money portion of the claim. This situation would be resolved by simply using the value of the car, allowing negative equity to be added to the claim to the extent of the car's value. Any remaining negative equity would be an unsecured claim. This formulation is consistent with the parties' rights under state law. The lender would realize only the value of the car and could assert the remainder as an unsecured deficiency claim.

PMSI blur the line between a security interest and a PMSI. They seem determined to protect the secured status of the negative equity portion, while ignoring the fact that, even if the creditor does not have a PMSI in the negative equity portion of the loan, the lender still has a security interest in the car.²¹⁴ The car is encumbered until the loan is paid. It does not matter if the debtor defaults when the balance is \$20,000, \$2,000 or \$200—the lender still has its collateral if the loan is in default. So although the negative equity portion of the loan destroys the purchase money nature of that particular portion of the security interest, the lender *still has* a security interest in the vehicle (outside of bankruptcy) until every dollar, including the negative equity, is paid back to the creditor.

In the wake of the financial crisis predicated on poor consumer lending practices, unwise transactions that leave a creditor tremendously undersecured and a consumer saddled with an unbearable loan should not be condoned by a process that prides itself on consistency and fairness. The bankruptcy process is designed to provide overburdened debtors with a fresh start by discharging their obligations while allowing similarly situated creditors an equal distribution of the bankrupt's assets. While it is true that BAPCPA attempts to cure and deter some of the most egregious abuses of the bankruptcy system, the stripping of negative equity from an auto loan is not one of them.

Debtors should be allowed to cram down the negative equity portion of their car loans, allowing the creditor an unsecured claim for the negative equity portion. This solution best allows Chapter 13 debtors to keep their cars—instruments that, for many debtors, allow them to keep working—and finish their payment plans. It also provides for equal distribution among claimants that are in the same position. Perhaps Congress meant to include negative equity in the definition of “purchase money security interest,” but until Congress clarifies the term by inserting an unambiguous definition into the Bankruptcy Code, federal courts are left to apply a term from the U.C.C. that was never intended to have meaning outside of the priority scheme set up by Article 9. Though eight circuit courts have ruled on this issue, the continuing dissents and the recent decision reached by the Ninth Circuit suggest that the answer to the negative equity question is not as obvious as the circuit courts have made it out to be.²¹⁵

Congress can and should simply define “purchase money security interest” in the Bankruptcy Code to clarify the extent to which it meant to

214. Indeed, a vehicle can be used as collateral for most types of consumer loans. *See* Ford v. Ford Motor Credit Corp. (*In re Ford*), 574 F.3d 1279, 1289 (10th Cir. 2009) (Tymkovich, J., dissenting) (“[T]he Fords and their dealer were free to use the new pickup as security for a loan to pay an antecedent debt . . .”).

215. As one court put it, the hanging paragraph “has become the ‘Rorschach Inkblot Test’ of the bankruptcy bench and bar.” *In re Busby*, 393 B.R. 443, 448 (Bankr. S.D. Miss. 2008).

protect overreaching creditors attempting to claim the protections of purchase money status. One solution might be to use a definition already contained in the Bankruptcy Code. Section 547(c)(3) provides that security interests that secure “new value” related to the purchase of collateral cannot be avoided as preferences.²¹⁶ “New value,” in turn, is defined as “money or money’s worth in goods, services, or new credit, . . . but does not include *an obligation substituted for an existing obligation.*”²¹⁷ The Ninth Circuit relied on this definition when it found that, while the Bankruptcy Code affords preferential treatment for certain types of security interests, that treatment is reserved for situations when “the obligation relates to the receipt of truly new value, not just old obligations that have been repackaged.”²¹⁸

Until Congress acts, courts faced with this issue should consider the purposes behind the protections afforded to purchase money creditors and determine whether car creditors should be entitled to these protections for the negative equity portion of the loan.

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216. 11 U.S.C. § 547(c)(3) (2006).

217. 11 U.S.C. § 547(a)(2) (emphasis added).

218. AmeriCredit Fin. Servs., Inc. v. Penrod (*In re Penrod*), No. 08-60037, 2010 U.S. App. LEXIS 14588, at *14 (9th Cir. July 16, 2010).

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