Negative Equity and Purchase-Money Security Interests under the Uniform Commercial Code and the BAPCPA

Geoffrey M. Collins

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NOTE
NEGATIVE EQUITY AND PURCHASE-MONEY SECURITY INTERESTS UNDER THE UNIFORM COMMERCIAL CODE AND THE BAPCPA

Geoffrey M. Collins†

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INTRODUCTION

In the context of the “hanging paragraph” of 11 U.S.C. § 1325(a), recent bankruptcy decisions have reached varying conclusions regarding whether a “purchase-money security interest” (PMSI)

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secures the portion of a retail automotive loan attributable to paying off the borrower's negative equity in a trade-in vehicle. On this issue, several circuit courts\(^1\) and the Ninth Circuit's Bankruptcy Appellate Panel\(^2\) have ruled, the Second Circuit is currently hearing a case,\(^3\) and the lower courts have decided numerous cases.\(^4\) This Note will provide a comprehensive survey of the positions of various courts and a critique and analysis of those positions and will argue for a legislative solution to the problem.

This question arose because of changes in the bankruptcy law enacted by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). Prior to 2005, in a Chapter 13 bankruptcy case, if a secured claim exceeded the value of collateral, the Bankruptcy Code treated any shortfalls as unsecured.\(^5\) This treatment meant that debtors could "cram-down" the secured portion of claims to the value of the collateral with the remainder being treated as unsecured.\(^6\) While debtors had to pay the secured portion in full, they received a discharge for the unpaid portion at the end of the plan.\(^7\) This occurred most frequently with automobile loans because the vehicles were often worth less than the remaining obligation.\(^8\) The difference in values increased when lenders rolled negative equity from trade-in vehicles into the new loans.

The BAPCPA changed those rules by adding the so-called "hanging paragraph" to 11 U.S.C. § 1325(a).\(^9\) This section is called the "hanging paragraph" because, although it appears at the end of § 1325(a), it is not numbered and is not directly connected to the previous numbered paragraph, which is 11 U.S.C. § 1325(a)(9).\(^10\)

The hanging paragraph essentially gives covered lenders secured

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\(^1\) See, e.g., In re Callicott, No. 09-1030, 2009 WL 2870501 (8th Cir. Sept. 9, 2009); In re Mierkowski, No. 08-3866, 2009 WL 2835386 (8th Cir. Sept. 8, 2009); In re Dale, No. 08-20583, 2009 WL 2857998 (5th Cir. Sept. 8, 2009); Graupner v. Nuvell Credit Corp. (In re Graupner), 537 F.3d 1295 (11th Cir. 2008).


\(^3\) See Reiber v. Gen. Motors Acceptance Corp., LLC (In re Peaslee), 547 F.3d 177 (2d Cir. 2008), certifying question to In re Peaslee, 2009 N.Y. slip op. 05197, 2009 WL 1766000 (N.Y. June 24, 2009). The Second Circuit certified the following question to the New York Court of Appeals: "Is the portion of an automobile retail instalment [sic] sale attributable to a trade-in vehicle's 'negative equity' a part of the 'purchase-money obligation' arising from the purchase of a new car, as defined under New York's U.C.C.~?" Id. at 186. The New York Court of Appeals, in a 4–3 split decision, answered this question in the affirmative. See In re Peaslee, 2009 N.Y. slip op. 05197, 2009 WL 1766000, (N.Y. June 24, 2009).

\(^4\) See infra Parts II and III.


\(^6\) See Penrod, 392 B.R. at 839–42 (discussing the relevance of purchase-money status).

\(^7\) Id. at 840.

\(^8\) Id.


\(^10\) Penrod, 392 B.R. at 840–41.
claims for the entire amounts of the loans. This paragraph is important because a Chapter 13 debtor must provide for payment in full of all secured claims instead of providing for payment of only the value of the collateral. Therefore, whether a claim qualified for treatment under the hanging paragraph became a key question.

For a creditor to qualify for the protections of the hanging paragraph on motor vehicle loans, a debtor must have incurred the obligation within 910 days of filing the petition and the vehicle must have been for the debtor’s personal use. For collateral consisting of “other thing[s] of value,” the debtor must have incurred the obligation within the preceding year. Finally, regardless of the type of collateral, the creditor’s security interest must be a PMSI. The vast majority of courts have held that the BAPCPA refers to state law found in U.C.C. § 9-103. “Purchase-money security interest” in a consumer good is a term that originated in the Uniform Commercial Code (U.C.C.), although the treatment of such interests is much like pre-Code law.

When applying the U.C.C. definition, identification of a PMSI is usually easy. A typical example is a seller of goods retaining an interest in those goods to secure the payment of all or some of the price of those goods. Third-party lenders can also retain a PMSI in a consumer good. This occurs when they make advances or incur obligations “to enable the debtor to acquire rights in or the use of the collateral” where those advances or obligations are “in fact so used” to acquire rights in that collateral.

Under the Uniform Commercial Code, a security interest in goods has purchase-money status “to the extent that the goods are purchase-money collateral with respect to that security interest.”

11 See 11 U.S.C. § 1325 (excluding loans meeting the hanging paragraph’s requirements from the operation of 11 U.S.C. § 506, the provision that previously allowed the “cram-down” of all secured loans in Chapter 13).
12 Id. § 1325(a) (5).
13 “Motor vehicle” is defined by 49 U.S.C. § 30102. Id. § 1325(a); see 49 U.S.C. § 30102(a)(6) (2006) (defining “motor vehicle” as “a vehicle driven or drawn by mechanical power and manufactured primarily for use on public streets, roads, and highways, [not including] a vehicle operated only on a rail line”).
15 Id.
16 Id.
18 See, e.g., 4 James J. White & Robert S. Summers, Uniform Commercial Code § 31-6(a) (5th ed. 2002) (discussing treatment of such interests both under the U.C.C. and pre-Code).
19 Id.
21 Id. § 9-103(b)(1).
"Purchase-money collateral" means "goods . . . that secure[ ] a purchase-money obligation incurred with respect to that collateral." A "purchase-money obligation" is "an obligation . . . 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." Banks making loans give value that allows the debtor to acquire rights in the vehicle to qualify for purchase-money status.

Loans that contain negative equity, which generally fall in the third-party-lender category, are more difficult. There are questions of whether the negative equity is "part of the price" or if it "enable[d] the debtor to acquire rights." In addition to these questions, courts have also disagreed on whether negative equity transforms an entire security interest into a non-purchase-money interest (applying the so-called "transformation" rule) or whether both purchase-money and non-purchase-money security interests secure such loans (the so-called "dual-status" rule).

The Bankruptcy Court for the Northern District of Ohio introduced an interesting federalism question when it held that, for purposes of the hanging paragraph, PMSI had a federal common-law definition and a PMSI did not secure negative equity. Judge Russ Kendig reasoned that, although the term originated in the Uniform Commercial Code, Congress did not specify that state law must apply for the definition and that this omission left interpretation of the term open to the federal judiciary. He further reasoned that federal policy conflicted with the use of state law. The federal bankruptcy policy of providing uniform treatment was failing, and there was no state interest in having the U.C.C. definition apply based on the U.C.C.'s comments disavowing its application to bankruptcy law. Although a number of courts have cited the Ohio decision, to date, no court has followed by applying a federal definition, thereby continuing the split in authority.

22 Id. § 9-103(a)(1).
23 Id. § 9-103(a)(2).
24 Id. § 9-103(a)(2).
28 See id. at 216–20.
29 See id. at 217.
30 See id. at 219.
31 See, e.g., In re Ford, 387 B.R. 827, 830–31 (Bankr. D. Kan. 2008), aff'd sub nom. Ford v. Ford Motor Credit Corp. (In re Ford), 574 F.3d 1279 (10th Cir. 2009); In re Look, 383
This split in authority, which the Westfall court characterized as a "maddeningly inconsistent body of decisions," leaves Chapter 13 debtors and creditors with little guidance. Debtors have only uncertain expectations of whether courts will permit negative equity to be crammed down and they face the increased expense of additional litigation on the question. Creditors, already faced with other difficulties in valuing subprime automotive loans, encounter added uncertainty regarding how courts will treat particular loans. The current economic climate and the importance of revenues from auto financing to struggling automotive manufacturers give this issue additional importance.

Part I of this Note will discuss the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), the change in the cram-down rules, and the effects of those changes. Part II will provide a comprehensive review of the current case law and describe the various approaches taken by the courts. Part III will discuss the outlier approach of the Northern District of Ohio. Part IV will analyze the decisions described in Parts II and III, argue that the Ohio Court erred by applying a federal definition, and finally argue that a federal legislative solution is both appropriate and desirable.

I  
Bankruptcy Abuse Prevention and Consumer Protection Act, Change in Cram-Down Rules

The Bankruptcy Code generally does not permit secured claims to exceed the value of the collateral securing the loan. Section 506(a)(1) provides that a claim is secured by the creditor’s interest in the bankruptcy estate’s interest in the collateral. The valuation standard for the estate’s interest is the “replacement-value” standard, 


32 Westfall, 376 B.R. at 213.
33 See Sharon Silke Carty, GMAC, Key to GM’s Survival, Gets $5 Billion in Federal Aid; Goal: Start Lending to ‘Broader Group’, USA TODAY, Dec. 30, 2008, at 3B (characterizing GMAC as “GM’s crown jewel”; noting that GMAC regularly outearned automotive operations for years; and providing the example that in 2006, a year in which GM’s auto operations lost $3.2 billion, “GMAC pulled in $2.2 billion”).
34 11 U.S.C. § 506(a)(1) (2006) (“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.”).
35 Id.
which sets the value at what the debtor would have to pay for comparable property. Because the estate's interest in the collateral is limited to the replacement value of the collateral, the creditor's interest limited to the estate's interest thus cannot exceed the value of that collateral. To the extent that a claim is greater than the creditor's interest, the Bankruptcy Code treats the claim as unsecured. The result is the bifurcation of the creditor's claim into secured and unsecured portions.

Prior to passing of the Bankruptcy Abuse Prevention and Consumer Protection Act, this bifurcation of the creditor's claim enabled Chapter 13 debtors to "cram-down" claims. A Chapter 13 plan's treatment of a secured claim could be confirmed if either the secured creditor accepted the plan, the debtor surrendered the collateral to the creditor, or the debtor chose to retain the collateral and exercised the 11 U.S.C. § 1325(a)(5)(B) "cram-down" power. This power would reduce the secured portion of the loan to the value of the collateral, with the remainder becoming unsecured. This was of special importance, because while the Chapter 13 plans were required to provide for payment of secured claims in full over the life of the plan, the court would discharge the remaining unsecured balance.

These provisions were particularly important in the context of automotive loans. Automotive loans are often "upside down," meaning that the value of the car securing the loan is less than the amount owed. The very nature of automobiles contributes to this problem because they tend to depreciate and lose market value quickly. Lending practices—such as six- and seven-year loan periods, zero-down loans, and high financing charges—have also contributed to the problem. As many as one in four consumers trading vehicles in has owed more on the trade-in vehicle than it is worth, and this figure

38 See id. § 1325(a)(5); Assocs. Commercial Corp., 520 U.S. at 957 (discussing application of 11 U.S.C. § 1325(a)(5) where a debtor chose to keep the collateral for use and exercise the "cram-down" power).
40 Id. at 840; see also 11 U.S.C. § 1328 (providing requirements for discharge).
41 See Robert Henderson, Understanding Finance: Auto Financing, MIAMI TIMES, Apr. 2–8, 2008, at 6D (advising consumers to avoid loans greater than four years due the depreciable value).
42 See Danny Hakim, Owning More on an Auto than It's Worth as a Trade-In, N.Y. TIMES, Mar. 27, 2004, at C1 (discussing, one year before the passing of BAPCPA, the escalation from 2001–04 of lending practices resulting in such loans); Henderson, supra note 41 (discussing financing practices that consumers should be wary of).
only accounts for those who are purchasing vehicles. Trade-in negative equity contributes to this problem by allowing buyers to start “upside down.”

Against this backdrop, the so-called “hanging paragraph” stepped in. The BAPCPA was the culmination of reform efforts over a number of years and the greatest change to the Bankruptcy Code since 1978. The Act, in what some have called an “uninformed rush by Congress to prevent bankruptcy abuse,” amended 11 U.S.C. § 1325. The amendment to section 1325 added the “hanging paragraph” after 11 U.S.C. § 1325(a)(9):

For purposes of [11 U.S.C. § 1325(a)] paragraph (5), section 506 shall not apply 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 preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle . . . acquired for the personal use of the debtor, or if collateral for that debt consists of any other thing of value, if the debt was incurred during the 1-year period preceding that filing.

If the hanging paragraph applies, it prevents “cram-down” in Chapter 13 cases. It operates by preventing section 506 from applying and bifurcating the creditor’s claim for purposes of section 1325(a)(5), which gives the conditions for plan approval relating to secured claims. Thus, for purposes of plan approval, the hanging paragraph treats the creditor as if it has a secured claim for the entire amount owed, regardless of the collateral’s value. Treating the creditor in this way requires the debtor to pay the full amount of such a

47 11 U.S.C. § 1325(a). For context, note the titles within the original act. The hanging paragraph appears in Title III, section 306(b) of the Act. Bankruptcy Abuse Prevention and Consumer Protection Act § 306(b). Title III is entitled “Discouraging Bankruptcy Abuse,” section 306 is entitled “Giving Secured Creditors Fair Treatment in Chapter 13,” and subsection (b), which carries the amendment, is entitled “Restoring the Foundation for Secured Credit.” Id.
49 Id. at 840.
loan because the court cannot approve a Chapter 13 plan that does not provide for the payment in full of the secured claim.\(^{50}\)

The hanging paragraph outlines five conditions for a creditor, in the context of a motor vehicle loan, to qualify for its protection: (1) the creditor must have a “purchase-money security interest” (PMSI), (2) that PMSI must secure the debt that is subject to the claim, (3) the debt must have been incurred within the 910 days preceding the filing of the petition, (4) the collateral must be a motor vehicle as defined by 49 U.S.C. § 30102, and (5) the motor vehicle must have been acquired for the personal use of the debtor.\(^{51}\) For debt not secured by automobiles, requirements three, four, and five are replaced by the requirements that (3) the collateral consist of any other thing of value, and (4) the debt must have been incurred during the year preceding the filing of the petition.\(^{52}\)

The requirement that a PMSI secure the debt is the subject of this Note. Although some dispute on the other requirements is possible, most of the requirements are easy to understand and the most problematic is the PMSI issue. This requirement is particularly important regarding negative equity financed into the loan because such negative equity will always be above the value of the car purchased, and therefore, depending on purchase-money status, it will be either wholly unsecured or wholly secured. Two major questions will determine the answer: (1) what law applies to define PMSI, and (2) under that law, what constitutes a PMSI.

### II

**Cases Applying (or Purporting to Apply) State Law**

The vast majority of cases have held that state law defines the term “purchase-money security interest” (PMSI) as used by the hanging paragraph.\(^{53}\) Courts applying state law to determine purchase-money status look to the various state enactments of section 9-103 of the Uniform Commercial Code.\(^{54}\) Those courts apply one of three

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\(^{50}\) See supra notes 34–40 and accompanying text. Of course, this assumes that the holder of the secured claim does not accept the plan. See 11 U.S.C. § 1325(a)(5)(A) (giving the alternative condition that “the holder of such claim has accepted the plan”).

\(^{51}\) 11 U.S.C. § 1325(a); see also Penrod, 392 B.R. at 841 (discussing the requirements of the “Hanging Paragraph”).

\(^{52}\) 11 U.S.C. § 1325(a).


\(^{54}\) See Graupner, 537 F.3d at 1301; Muldrew, 396 B.R. at 923–26; Horne, 390 B.R. at 197; Wall, 376 B.R. at 770–71; Peaslee, 373 B.R. at 258; Citifinancial Auto, 369 B.R. at 45.
rules regarding the purchase-money status of negative equity financed into the otherwise purchase-money loan. These rules are: (1) a PMSI secures the negative equity;\(^{55}\) (2) the so-called transformation rule, under which a PMSI does not secure the negative equity and the presence of a non-purchase-money obligation transforms the entire obligation into a non-purchase-money debt;\(^{56}\) and (3) the so-called dual-status rule, which bifurcates the loan into purchase-money and non-purchase-money obligations.\(^{57}\) This Part will examine the Uniform Commercial Code definition and these three approaches. Part III will address which rule is the better approach.

In the consumer goods context, the Uniform Commercial Code defines PMSI in section 9-103(b)(1).\(^ {58}\) A security interest is a PMSI "to the extent that the goods are purchase-money collateral with respect to that security interest."\(^ {59}\) Section 9-103(a)(1) defines "purchase-money collateral" as "goods . . . that secure[ ] a purchase-money obligation incurred with respect to that collateral."\(^ {60}\) A "purchase-money obligation" is defined in section 9-103(a)(2) as "an obligation . . . 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."\(^ {61}\)

This definition provides two categories of PMSI: sellers who retain an interest to secure payment of part of the price achieve purchase-money status through the first category for obligations incurred "as all or part of the price"; and third parties—such as banks—achieve purchase-money status through the second category for "value given to enable."\(^ {62}\) Most negative-equity cases involve third-party finance companies and therefore fall into the "value given" category.\(^ {63}\)

\(^{55}\) See, e.g., Graupner, 537 F.3d at 1303; Muldrew, 396 B.R. at 924; Wall, 376 B.R. at 770–71.


\(^{59}\) Id.

\(^{60}\) Id. § 9-103(a)(1).

\(^{61}\) Id. § 9-103(a)(2).

\(^{62}\) See generally 4 WHITE & SUMMERS, supra note 18 (discussing purchase-money status).

\(^{63}\) See, e.g., In re Price, 562 F.3d 618 (4th Cir. 2009); Graupner v. Nuvell Credit Corp. (In re Graupner), 537 F.3d 1295 (11th Cir. 2008); Gen. Motors Acceptance Corp. v. Horne,
The difficulty of determining whether negative equity can qualify for purchase-money status centers on whether it is part of the "price" or "value given" to enable a debtor to acquire rights in the collateral. Regarding "price" or "value given to enable," official Comment 3 of U.C.C. § 9-103 states that the terms include "obligations for expenses incurred in connection with acquiring rights in the collateral, sales taxes, duties, finance charges, interest, freight charges, costs of storage in transit, demurrage, administrative charges, expenses of collection and enforcement, attorney's fees, and other similar obligations." As mentioned previously, a court can apply one of three rules: negative equity as a PMSI, the transformation rule, or the dual-status rule.

A number of courts, including the Eleventh and Fourth Circuits, have held that a PMSI does secure negative equity in this type of loan and that therefore negative equity does not eliminate the purchase-money status of the obligation. Though purportedly applying state law, courts in this category often cite Congress's intent to provide protection for creditors. Regarding "price," some of these courts read U.C.C. § 9-103 in pari materia with the definition of "cash sales price" or "cash price" in motor vehicle statutes and conclude that a distinction exists between "cash price" and "price." In addition, many courts point to the "other similar obligations" language of U.C.C. § 9-103 Comment 3. Courts also cite the "close nexus" between the financing of negative equity and the acquisition in determining that the two were "part of a single transaction," giving that transaction purchase-money status. Finally, in choosing not to apply the dual-status rule, which would still provide some protection to creditors, courts point to the wording of the BAPCPA, which says that the cram-down provision will not apply if the creditor has a PMSI securing the debt; some courts read this language to mean a PMSI securing any part

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65 U.C.C. § 9-103 cmt. 3 (emphasis added).
66 See supra notes 55-57 and accompanying text.
67 See Price, 562 F.3d 618; Graupner, 537 F.3d at 1301-03.
68 See, e.g., Peaslee, 373 B.R. at 261; see also In re Long, 519 F.3d 288, 294 (6th Cir. 2008) (discussing Congress's intention to use the hanging paragraph to provide protection for creditors in cases involving surrenders of collateral).
69 In pari materia (Latin for "in the same matter") refers to a canon of construction that statutes in pari materia be construed together to resolve inconsistencies in one statute by looking at another statute on the same subject. See BLACK'S LAW DICTIONARY 862 (9th ed. 2009).
71 E.g., Graupner, 537 F.3d at 1301.
72 Cohrs, 373 B.R. at 110.
of the debt, rather than meaning a PMSI securing the full amount of the debt (which could only be satisfied if a PMSI secured negative equity).73

The New York Court of Appeals, the only state high court to address this issue, used similar reasoning in answering a certified question from the Second Circuit. The court first addressed “price” and “value given” and gave both of these terms a “broad interpretation.”74 The court also looked to the use of the term “price” in the New York Motor Vehicle Retail Installment Sales Act, under which negative equity is included in the “cash sale price.”75 Finally, the court looked to Comment 3 of U.C.C. § 9-103 and reasoned that because a buyer would often not be able to purchase a new vehicle without the financing of negative equity, a “close nexus” existed.76

By delivering a split opinion, the court failed to provide an answer that is likely to bring unity to future cases. An authoritative statement from the New York Court of Appeals, a highly influential court on U.C.C. matters, might have had this effect. However, in a powerful dissent, Judge George Bundy Smith showed flaws in the majority’s reasoning.77 Judge Smith criticized the majority for failing to consider the purpose of a PMSI and seeming to interpret the hanging paragraph rather than Article 9 of the U.C.C. He pointed out that a PMSI serves the function of giving a creditor who makes the purchase of goods possible first claim to those goods. He rephrased the issue as: “Is a lien resulting from the refinancing of a trade-in vehicle’s ‘negative equity’ entitled to the special priority given PMSIs over other liens by UCC article 9?” He reasoned that the answer must be no because “a loan procured to satisfy a pre-existing debt’ is inconsistent with the

73 See 11 U.S.C. § 1325(a) (2006) (“[S]ection 506 shall not apply to a claim . . . if the creditor has a purchase money security interest securing the debt that is the subject of the claim . . . .” (emphasis added)). Note that under this reasoning, the result would be the same under the dual-status rule. Following this reasoning, applying the state law dual-status rule, a PMSI would secure part of the claim; therefore, section 506 would not apply. Courts applying the dual-status rule have generally bifurcated claims. See, e.g., Citifinancial Auto v. Hernandez-Simpson, 369 B.R. 36 (D. Kan. 2007). However, the District Court for the Western District of Texas applied the state law dual-status rule but held that the hanging paragraph still prohibited cram-down of the non-purchase-money portion of the debt because a PMSI secured the remainder of the debt. In re Sanders, 405 B.R. 435, 444–45 (W.D. Tex. 2009) (“[T]he hanging paragraph applies to [the creditor’s] claim regardless of whether the charge for negative equity constitutes a purchase-money obligation.”).


75 Id.

76 Id. slip op. at 5.

77 The majority opinion coincides with a trend in the federal circuit courts toward holding that a purchase-money security interest secures negative equity. See infra note 161. How influential Judge Smith’s reasoning will be remains to be seen.

78 Peaslee, 2009 WL 1766000, slip op. at 5.
basic idea of a PMSI.” Concerned that the court was confusing the state law and federal law questions, Judge Smith worried that the majority’s decision would cloud other Article 9 issues. Whether or not that is true, the split decision makes it unlikely that the court’s pronouncement will end the debate.

As one would expect, courts deciding that portions of loans attributable to negative equity are not purchase-money obligations reason that those portions are not part of the “price” of the collateral. These courts find alternative support in U.C.C. § 9-103 Comment 3. For example, in In re Sanders, the Bankruptcy Court for the Western District of Texas reasoned that the items listed were “expense items” that were dissimilar from negative equity. The Middle District of Florida’s Bankruptcy Court reasoned that it was unlikely that the omission of negative equity from the comment was an oversight because negative equity differed in both “type” and “magnitude” from the listed expenses. Regarding the in pari materia argument, the Bankruptcy Court for the Middle District of Florida reasoned that the term “price of collateral” was not ambiguous, and therefore the in pari materia doctrine did not apply. The Ninth Circuit’s Bankruptcy Appellate Panel held that negative equity does not enable acquisition of the collateral. Regarding nexus between acquisition of the collateral and the debt, these courts characterize the exchange as “two separate financial transactions memorialized on a single retail installment contract.” These courts also find problems with whether the negative equity provides direct assistance, whether the value given was “in fact so used” to secure rights in the collateral, and whether negative equity financing was required to purchase the collateral.

For courts holding that a PMSI does not secure negative equity, the first approach is the “transformation rule.” Under the transformation rule, the presence of negative equity takes the entire claim out of

84 See Penrod, 392 B.R. at 850–52.
86 See Penrod, 392 B.R. at 848–51.
the protections of the hanging paragraph. Bankruptcy courts in a number of districts have adopted this rule; however, no district or circuit court has followed. Courts applying this rule construe the hanging paragraph narrowly. The Bankruptcy Court for the Western District of Texas compared the hanging paragraph to other provisions of the Bankruptcy Code using language such as “to the extent of” as evidence that Congress did not intend dual-status treatment in this context.

The dual-status rule is far more forgiving to creditors; under the dual-status rule, claims are bifurcated into purchase-money and non-purchase-money debts, and the hanging paragraph applies only to the purchase-money component of the claim. Revised Article 9 of the Uniform Commercial Code mandates this treatment in the commercial context but leaves to the courts to determine the appropriate rule.

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89 See, e.g., Graupner v. Nuvell Credit Corp. (In re Graupner), 537 F.3d 1295, 1300–03 (11th Cir. 2008) (holding that negative equity did not affect purchase-money status); Penrod, 392 B.R. at 858 (“[T]he analysis [behind the transformation rule] turns on the assumption that ‘debt’ refers to a unitary concept that cannot be divided. But the rest of the Code belies this assumption . . . .”); Gen. Motors Acceptance Corp. v. Peaslee, 375 B.R. 252, 262 (W.D.N.Y. 2007) (rejecting bankruptcy court decisions that held that a PMSI did not secure amounts attributable to negative equity and therefore not reaching the issue of transformation rule versus dual-status rule); In re Wall, 376 B.R. 769, 771 (Bankr. W.D.N.C. 2007) (holding that negative equity did not affect purchase-money status).
90 See, e.g., In re Sanders, 377 B.R. 836, 860 (Bankr. W.D. Tex. 2007) (“Congress could certainly have drafted this provision to cover a broader class of creditors had it so intended.”), rev’d, 403 B.R. 435 (W.D. Tex. 2009).
92 This may raise the issue of whether the choice of the dual-status versus the transformation rule should be a federal question. Some courts, such as the Bankruptcy Appellate Panel of Ninth Circuit, have chosen to apply state law to determine that a PMSI does not secure the negative equity and apply federal law to the choice of the dual-status versus the transformation rule. See Penrod, 392 B.R. at 843–55, 855–56; see also Sanders, 377 B.R. at 860 n.21 (noting that the court’s interpretation did not come from the U.C.C. or state transformation rules but from the “plain language of the [Bankruptcy] Code,” which the court interpreted as requiring that all of a creditor’s claim be secured by the creditor’s purchase-money security interest). Part IV addresses problems with this choice. See infra Part IV. The District Court for the Western District of Texas avoided some of these problems by concluding that the hanging paragraph covered the entire debt as long as some portion of the debt was secured by a PMSI. See Sanders, 403 B.R. 435 at 444–45 (reversing the bankruptcy court’s holding that the presence of a non-purchase-money obligation in the debt moved the entire amount out of the protection of the hanging paragraph).
93 See, e.g., Penrod, 392 B.R. at 859 (“The Dual Status Rule gives lenders a PMSI equal to the new value financed . . . and a regular security interest for the balance.”).
in consumer transactions. The Ninth Circuit Bankruptcy Appellate Panel pointed to this default rule for non-consumer transactions in support of applying a dual-status rule. Although not addressing negative equity in particular, in their treatise on the Uniform Commercial Code, Professors James J. White and Robert S. Summers assert that courts should apply the business (dual-status) rule by analogy in some consumer cases. White and Summers discuss loans that included the refinancing of previous purchase-money debts owed to the same lender, a different situation than the automotive context, where the negative equity financed is often from another lender. However, under the business (or not "consumer goods") rule of U.C.C. § 9-103(f), these loans would still be treated under the dual-status rule. Applied to the automotive context, where the negative equity is from another lender, the rule states that a PMSI "does not lose its status as such, even if . . . the purchase-money collateral also secures an obligation that is not a purchase-money obligation." The underlying issue in both situations is whether a document could create both purchase-money and non-purchase-money security interests. Courts applying the dual-status rule often have characterized the transformation rule as being too harsh on creditors.

Regarding choice of the foregoing rules, no clear winner has emerged. As the following chart demonstrates, to date, at the circuit-court level, the Eleventh, Eighth, Fifth, and Fourth Circuits and the Ninth Circuit Bankruptcy Appellate Panel have ruled on the issue. Several district courts have ruled on the issue, holding either that a

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94 See U.C.C. § 9-103(f) (2006) ("In a transaction other than a consumer-goods transaction, a purchase-money security interest does not lose its status as such, even if: (1) the purchase-money collateral also secures an obligation that is not a purchase-money obligation . . . ."); id. § 9-103(h) ("The limitation [of § 9-103(f) to non-consumer transactions] is intended to leave to the court the determination of the proper rules in consumer-goods transactions. The court may not infer from that limitation the nature of the proper rule in consumer-goods transactions and may continue to apply established approaches."). But cf. Citifinancial Auto v. Hernandez-Simpson, 369 B.R. 36, 45–48 (D. Kan. 2007) (applying the Kansas version of the Uniform Commercial Code, KAN. U.C.C. ANN. § 84-9-103 (West 2008), which did not include the limiting language in U.C.C. §§ 9-103(f) and (h)).

95 Penrod, 392 B.R. at 859 ("[T]he Dual Status Rule, as the default rule under Article 9, essentially captures both the lender's reasonable expectations and the debtor's economic situation, and is consistent with the apparent purpose of the hanging paragraph.").

96 See 4 WHITE & SUMMERS, supra note 18, § 31-6(a), at 137 (discussing loans, including refinancing, and stating that "[i]n these cases we believe the courts should apply the business rule by analogy").

97 See U.C.C. § 9-103(f).

98 Id.

99 In re Westfall, 376 B.R. 210, 219 (Bankr. N.D. Ohio 2007) ("Simply, application of the transformation rule is too severe.").

100 See In re Price, 562 F.3d 618 (4th Cir. 2009) (holding that a purchase-money security interest secured negative equity); Graupner v. Nuvell Credit Corp. (In re Graupner), 537 F.3d 1295, 1302–03 (11th Cir. 2008) (same); Penrod, 392 B.R. at 860 (applying the dual-status rule).
NEGATIVE EQUITY

PMSI secured the negative equity or that the dual-status rule applied. The bankruptcy courts of the various circuits have applied all three rules. The following chart of cases is organized by the state whose law is being applied, then by level of court, and then finally by date. In the “Rule” column of the chart, decisions holding that a PMSI secures negative equity are designated “Y,” those applying the dual-status rule are designated “D,” and those applying the transformation rule are designated “T.”

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The Bankruptcy Court for the Northern District of Ohio reached a unique conclusion in its decision in *In re Westfall*. Feeling impelled to the conclusion that a consistent rule of law was needed by the "maddeningly inconsistent body of decisions," the court held that a federal definition was appropriate. The court had initially concluded that the creditor’s interests were wholly non-purchase-money by applying the transformation rule from Ohio state law. However, the court then requested and received additional briefing on the choice-of-law issue and went on to conclude that the statute called for a federal definition of "purchase-money security interest." The court concluded that, under this federal definition, a PMSI did not secure negative equity and the dual-status rule applied, allowing the debtor to bifurcate the claim.

### A. Application of the Current Choice of Law Standard

To determine if a federal definition was appropriate, the court looked initially to the three-prong standard enunciated by the Eleventh Circuit in *Dzikowski v. Northern Trust Bank of Florida*. The Eleventh Circuit had summarized the considerations as “[1] the need for uniformity, [2] whether application of state law frustrates important federal policies, and [3] the impact of federal common law on preex-
isting commercial relationships premised on state law.”109 The Westfall court characterized application of the Dzikowski standard as a “muddle on the current facts.”110

Regarding the uniformity prong, the Westfall court noted that uniformity encouraged adoption of a federal definition in order to “promote similar treatment of debtors and creditors.”111 The court did not view the argument as being dispositive.112 It reasoned that uniformity was a key factor “when there is a threat that a federal right would be impinged or diminished”113 but then determined that no such federal right was at stake in this situation.114

The court concluded that it could not satisfy the second prong of the test—whether use of state law impermissibly abridged core federal policies of the Bankruptcy Code—because of unclear congressional intent regarding the extent of the protection afforded by the hanging paragraph.115 To determine if a conflict existed, the court quoted the Sixth Circuit’s test from the context of conflict preemption, stating that a conflict is found “where it is impossible to comply with both federal and state law, or where state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.”116 Addressing this prong of the test, the court concluded that there was “no way to delineate the extent of the protection” that Congress intended the hanging paragraph to provide.117

After briefly noting that a federal definition provided no greater disruption to transactions traditionally governed by state law than would exist otherwise, the court concluded that the established standard was “a muddle on the current facts.”118 Rather than addressing whether the “muddle” meant that state or federal law should apply, the court, citing no authority, decided that the “ill-fitting drape of the

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109 Dzikowski, 478 F.3d at 1298 (citing Redwing Carriers, Inc. v. Saraland Apartments, 94 F.3d 1489, 1501 (11th Cir. 1996)).
110 Westfall, 376 B.R. at 216.
111 Id. at 215.
113 Id.
114 Id. Note that the court gave the following rule to make that determination: "'[A] conflict is found where compliance with both federal and state regulations is a physical impossibility, or where state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.'" Id. (quoting 2 Norman J. Singer, Sutherland Statutory Construction § 36:9 (6th ed. 2006)). This test is strikingly similar to the test articulated for the second prong of whether the use of state law impermissibly abridges core federal policy. See supra note 109 and accompanying text.
115 See Westfall, 376 B.R. at 216.
116 Id. (quoting Pertuso v. Ford Motor Credit Co., 233 F.3d 417, 425 (6th Cir. 2000)).
117 Id. (discussing the sparse legislative history and noting that most courts conclude that the intent of the hanging paragraph was to protect creditors from cram-downs, but concluding that there was no way to delineate the extent of that protection).
118 Id.
rule of decision cloth serves as proof of the necessity of an exception on these unique facts."\textsuperscript{119} The court went on to apply what it called the "excluded purpose" exception.\textsuperscript{120}

B. Westfall Court Applies the "Excluded Purpose Exception"

The Westfall Court articulated its "excluded purpose exception" as meaning that "a state statute should not serve as a federal rule of decision if the federal purpose was excluded from the state law."\textsuperscript{121} The court's analysis largely depended on the following language from Comment 8 from U.C.C. § 9-103:

Whether a security interest is a "purchase-money security interest" under other law is determined by that law. For example, decisions under Bankruptcy Code Section 522(f) have applied both the dual-status and the transformation rules. 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.\textsuperscript{122}

After a discussion of the use of the comments in interpreting the provisions of the U.C.C., the court asserted that its use of Comment 8 did not involve the "most common objection to use of the Comments."\textsuperscript{123} The court declared that it was using the comment not to interpret the statute but merely to illustrate that the application of the state law here was beyond its intended scope.\textsuperscript{124} The court stated that because of the U.C.C. drafters' "intentional non-decision" and the "far from comprehensive" state case law, attempting to divine state law on this subject was similar to "divining water with a forked stick."\textsuperscript{125} This lack of authority, combined with the language of the comments specifically stating that the drafters did not intend to apply section 9-103 to law outside of the U.C.C., led the court to conclude that there was no strong state interest in applying the state definition in this context.\textsuperscript{126}

C. Cited, Misunderstood, and Not Followed: Subsequent Treatment of In re Westfall

No court has followed In re Westfall in its choice to apply a federal definition for PMSI. Of the cases that have cited Westfall, a number of

\begin{itemize}
  \item[] \textsuperscript{119} Id.
  \item[] \textsuperscript{120} Id. Part III.B will describe the Westfall court's application of the excluded-purpose exception. Part III.B will not provide any critical analysis of this approach. However, this Note will argue in Part IV that this exception is both inappropriate and logically flawed.
  \item[] \textsuperscript{121} Westfall, 576 B.R. at 216.
  \item[] \textsuperscript{122} U.C.C. § 9-103 cmt. 8 (2006).
  \item[] \textsuperscript{123} Westfall, 576 B.R. at 217-18.
  \item[] \textsuperscript{124} See id. at 218.
  \item[] \textsuperscript{125} Id. at 219.
  \item[] \textsuperscript{126} See id.
them have merely cited Westfall as support for the dual-status rule without mentioning the choice-of-law question, which made Westfall unique.\textsuperscript{127} Several courts have noted the choice of a federal rule but have declined to follow.\textsuperscript{128} Other courts have cited Westfall positively on other issues without noting the federalism issue but not for support of the dual-status rule.\textsuperscript{129} In its opinion certifying to the New York Court of Appeals the question of whether a PMSI secured negative equity, the Second Circuit cited In re Westfall twice for other points without mentioning the federalism question.\textsuperscript{130} Clearly based on this history, the Westfall court’s hope of providing a uniform federal rule and giving clarity to this area of the law has not materialized.

IV
ANALYSIS

A. Analysis Introduction

This Part will begin by examining two approaches to the choice-of-law question. Both of these approaches choose federal law to some


\textsuperscript{130} See Reiber v. Gen. Motors Acceptance Corp., LLC (In re Peaslee), 547 F.3d 177, 184-85, 184 n.10 (2d Cir. 2008) (quoting the Westfall court’s characterization of the case law as a “maddeningly inconsistent body of decisions” and citing Westfall for treatment of the U.C.C. comments). The Second Circuit did not address or follow Westfall regarding choice of law and concluded, at least for purposes of certifying the U.C.C. question to the New York Court of Appeals, that state law governs the definition of PMSI. See id. at 184 (“We... believe furthermore that state law governs the definition of PMSI in the hanging paragraph.”).
extent to determine purchase-money status. While both approaches, if uniformly adopted, would provide more certain answers than applying state law, this Note will argue that both approaches contain major flaws in reasoning. Next, it will argue that Congress intended for state law to apply and will provide analysis of the author’s opinion of the best answer under amended Article 9 of the Uniform Commercial Code. Finally, this Part will argue that, given the current situation and economic climate, Congress should modify the hanging paragraph to provide a uniform answer.

B. Choice of Law

1. State Law Determining What Congress Meant? The Problem with Westfall

Judge Kendig was mistaken in *In re Westfall* to apply a federal definition of PMSI. The plain-meaning doctrine supports application of the Uniform Commercial Code. The Uniform Commercial Code is the authority cited by *Black’s Law Dictionary* for its definition of a PMSI, which coincides with U.C.C. § 9-103. The language of the hanging paragraph itself gives no other definition, although it provides a specific definition of the term “motor vehicle.” The legislative history provides no indication of any other definition.

Judge Kendig’s “excluded purpose” exception is inherently incoherent, a problem that may explain the lack of authority cited. The language of Comment 8, even if one were to assume that it was a binding interpretation of the U.C.C., is merely a truism. Ironically, Judge Kendig’s exception violates that truism. The Comment concludes, “Where federal law does not defer to this Article, this Article does not, and could not, determine a question of federal law.” By looking to state law, written prior to the enactment of the BAPCPA, Judge Kendig determined that Congress could not have chosen to defer to state law as a rule of decision under the BAPCPA. He could have meant that Congress must have been aware of Comment 8 and must have chosen to respect it, but he provided no evidence in the legislative history to justify such an assertion. Instead, he seemed to be implying that the state law itself excludes this purpose. This reading has the state law choosing the federal rule of decision rather than the federal

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133 Compare 11 U.S.C. § 1325(a) (2006) (stating as to purchase-money security interests only that "section 506 shall not apply to a claim ... if the creditor has a purchase money security interest"), with 11 U.S.C. § 1325(a) (providing a cross-reference to 49 U.S.C. § 30102 for a definition of "motor vehicle").

134 See *infra* Part IV.C (discussing the limited legislative history of the provision).

rule of decision choosing to look to state law. In the words of Com-
ment 8, state law is determining the federal-law question of whether to
look to the state law. Of course, state law itself cannot determine fed-
eral law. Unfortunately, this answer does not assist with the question
of whether Congress intended to look to state law. Part IV.C examines
this question.

2. Splitting the Baby—Where the Ninth Circuit Went Wrong

The Ninth Circuit Bankruptcy Appellate Panel, in In re Penrod, was
mistaken in the application of state law to answer that a PMSI did
not secure the negative equity and the application of federal law to
determine that the “dual-status” rule applied. Under this rule, a
federal court would apply the dual-status rule regardless of whether
the state involved had adopted the transformation rule in negative-
equity situations. This splitting-the-baby approach—similar to the
approach of the Bankruptcy Court for the Western District of Texas—
while purporting to apply state law to determine purchase-
money status, does not apply state law and is unsound.

Under the Uniform Commercial Code, one cannot separate the
questions of whether a PMSI secures a debt and whether the dual-
status or the transformation rule applies because the latter question
necessarily answers the former. For example, consider a situation
where the state law holds that a PMSI does not secure negative equity,
but the claim includes a portion that would have purchase-money sta-
tus if no other amounts were included. If one stopped at this point,
without answering the question of dual-status or transformation, the
only question answered is a purely hypothetical one: “If no other
amounts were included, would a PMSI secure this portion (not includ-
ing the negative equity) of the claim?” Whether a PMSI actually does
secure that portion depends on whether the dual-status or transforma-
tion rule applies. If the transformation rule applies, no PMSI secures
any portion of the claim. If the dual-status rule applies, a PMSI
secures the part of the claim having purchase-money status. The ques-
tion of dual-status rule or transformation rule is actually a question of
which of two definitions applies.

137 See id. at 859.
138 See id. (discussing the distinction between applying the dual-status rule as the state law and adopting the dual-status rule as a uniform federal rule).
139 See In re Sanders, 377 B.R. 836, 860 & n.20 (Bankr. W.D. Tex. 2007) (applying state law to determine that negative equity was not secured by a PMSI and holding that the hanging paragraph required that if part of the claim was not secured by a PMSI then the hanging paragraph did not apply), rev’d, 403 B.R. 435 (W.D. Tex. 2009).
The Bankruptcy Appellate Panel of the Ninth Circuit did not seem to appreciate the significance of choosing between the dual-status and transformation rules. Because the choice of dual-status or transformation rule is a choice between definitions, the panel in fact interpreted the statute to create a federal definition for PMSI in situations involving negative equity. One could phrase this definition as follows: a PMSI secures a claim to the extent that there is a portion of the claim that under the relevant state law a PMSI would secure if that portion were isolated from all other portions of the claim. When phrased this way, one would naturally question whether the simple language of the hanging paragraph could support such a complicated interpretation. 

The lack of any statement regarding choice of law or definition argues against Congress having intended to adopt such a complicated rule of decision.

Although one could read the lack of statement regarding choice of law to imply using only a state-law definition, one could determine—as did the court in In re Penrod—that a split definition should apply. Even though applying the dual-status rule in this situation is not coherent, applying the transformation rule is less problematic. The Bankruptcy Court for the Western District of Texas took this approach in In re Sanders.

The court in In re Sanders applied the transformation rule as a federal rule for purposes of the hanging paragraph. The court concluded that narrowing the exception of the hanging paragraph by requiring that a PMSI secure the entire claim "comports best with accepted canons of statutory construction." This rule does not suffer from the same problems as the Ninth Circuit Bankruptcy Appel-

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140 See Penrod, 392 B.R. at 859 n.25 (using language that limited the application of the federal rule to negative-equity situations and stating that, "adopting the Dual Status Rule as a uniform federal rule, . . . we would apply the Dual Status Rule even if, under the majority version of UCC § 9–103(h), a state decided to adopt the Transformation Rule in negative equity situations" (emphasis added)).

141 See 11 U.S.C. § 1325(a) (2006) (using much simpler language with no mention of a split definition). To be fair, the court could have reached an identical, less problematic result by interpreting the language of the hanging paragraph to apply to any obligation that is secured at least in part by a PMSI. This approach was taken by the District Court for the Western District of Texas. Sanders, 403 B.R. 435, rev'g Sanders, 377 B.R. 836; see also infra notes 132–35 and accompanying text. However, the Ninth Circuit Bankruptcy Appellate Panel grounded its decision in the definition of PMSI, not an interpretation of whether the hanging paragraph required the entire obligation to be secured by a PMSI. See generally Penrod, 392 B.R. 835.

142 See infra Part IV.D.

143 See supra Part IV.B.2 (discussing incoherence in the Ninth Circuit Bankruptcy Appellate Panel's approach in In re Penrod).

144 See Sanders, 377 B.R. at 864 ("[S]ection 1325(a) of the Bankruptcy Code affords special protection . . . so long as the purchase money security interest secures all of the debt comprising the creditor's claim.").

145 Id.
late Panel’s dual-status-rule approach in *In re Penrod*. State law determines whether a PMSI secures all or part of the claim by applying its version of the U.C.C., which will use either the dual-status or the transformation rule. The federal rule, as articulated by the court in *In re Sanders*, determines not PMSI status but whether or not a PMSI must secure the *entire* amount of the claim for the claim to fall under the protection of the hanging paragraph.\(^{146}\)

This rule functions differently from applying a federal “dual-status” rule. If the state law applies the dual-status rule, then a PMSI would not secure the *entire* amount; the *Sanders* rule would then deny protection of the hanging paragraph, a result similar in effect to a state-law transformation rule. If the state law applies the transformation rule, then a PMSI would not secure *any* amount, and again, the hanging paragraph would not apply. If the state law held that a PMSI secured negative equity, and no other non-purchase-money obligations were included, then a PMSI would secure the *entire* amount.

C. Congress Meant for State Law to Control

Three courts—the Ninth Circuit Bankruptcy Appellate Panel, the Bankruptcy Court for the Western District of Texas, and the Bankruptcy Court for the Northern District of Ohio—have applied federal law to some extent. As demonstrated above, all three approaches are less than desirable, and the opinions of both the Ninth Circuit Bankruptcy Appellate Panel and the Bankruptcy Court for the Northern District of Ohio contain serious flaws in reasoning. The Bankruptcy Court for the Western District of Texas made less serious errors in determining that federal law should apply; however, its textualist argument failed to address congressional intent.

The plain language of the statute indicates that state law controls. The term “purchase-money security interest” originated in the Uniform Commercial Code. Indeed, the only authority *Black’s Law Dictionary* cites for its definition of a PMSI is the Uniform Commercial Code.\(^ {147}\) The term is not defined in the Bankruptcy Code, even though it is used both in the hanging paragraph and in 11 U.S.C. § 522(f).\(^ {148}\) In this regard, the court in *In re Sanders* did not err. The *Sanders* court asserted that the language clearly indicates that a PMSI must secure the *entire* claim for it to qualify under the hanging paragraph. Although the court makes a reasonable argument for this reading, it does not address Congress’s intent for state law to apply.

\(^{146}\) See id. (holding that, because the claim included purchase-money and non-purchase-money security interests, it did not qualify for the protection of the hanging paragraph).

\(^{147}\) *BLACK’S LAW DICTIONARY* 1478 (9th ed. 2009).

Some courts and commentators have lamented the lack of legislative history for the hanging paragraph. However, as one court put it, the "only clear intent discerned from the legislative history of the hanging paragraph is that Congress intended to provide more protection to creditors with purchase-money security interests."\textsuperscript{149} The paragraph's position within the BAPCPA supports this argument. It is section 306 of Chapter 13 of the Act. Section 306 is entitled "Giving Secured Creditors Fair Treatment in Chapter 13," and it appears in a chapter of the BAPCPA entitled "Restoring the Foundation for Secured Credit."\textsuperscript{150} The House Judiciary Committee's report recommending the passage of the bill discusses the hanging paragraph in two places; in both, it discusses only protection of secured creditors.\textsuperscript{151} There is also some evidence that Congress wanted to make Chapter 13 less attractive to debtors.\textsuperscript{152}

Though the Sanders court makes a plausible argument, given the clear intent of the hanging paragraph, the result, similar to the state-law transformation rule, does not meet the congressional intent. The result is too narrow to provide the type of protection that Congress seems to have envisioned. The application chosen by the Penrod court does not reflect the language of the statute and is incoherent. Given these issues, the general meaning of PMSI as a state-law term from the U.C.C. and the lack of legislative history regarding a more complex choice-of-law rule, Congress must have intended state law to apply.

D. Uniform Commercial Code Application

In applying state law, the better answer is that a PMSI does not secure negative equity and the dual-status rule should apply.

The U.C.C. defines a PMSI in section 103 of Article 9. Under the U.C.C., a security interest is a PMSI to the extent that the goods—in this case the motor vehicle—"are purchase-money collateral with respect to that security interest."\textsuperscript{153} Section 9-103(a)(1) defines "purchase-money collateral" as "goods . . . that [secure] a purchase-

\textsuperscript{149} In re Duke, 345 B.R. 806, 809 (Bankr. W.D. Ky. 2006) (discussing intent in the context of deciding whether, pursuant to the hanging paragraph, surrender of motor vehicles to creditors would result in a full satisfaction of the creditor's claims).


\textsuperscript{151} See H.R. REP. NO. 109-31, at 17 (2005) (labeling discussion as "Protections for Secured Creditors"); id. at 71-72 (describing the application of the hanging paragraph).

\textsuperscript{152} Oversight of the Implementation of the Bankruptcy Abuse Prevention and Consumer Protection Act: Hearing Before the Subcomm. on Administrative Oversight and the Courts of the S. Comm. on the Judiciary, 109th Cong. 34 (2006) (statement of Sen. Sessions, Member, S. Comm. on the Judiciary) (providing an example of how the law removed some of the incentives for Chapter 13 filing and identifying the anti-cramdown provision of the hanging paragraph as one such provision).

money obligation incurred with respect to that collateral."

Which part of the language of U.C.C. § 9-103(a)(2) should apply depends on whether the creditor was the seller or a third-party lender. For third-party lenders, the first half of § 9-103(a)(2), the "part of the price" language does not apply. The "part of the price" language refers to sellers who accept an obligation to themselves from the obligors. The correct focus in those cases is on the following language from U.C.C. § 9-103(a)(2): "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." Therefore, for third-party lenders the focus becomes whether value given by a third-party lender to pay for negative equity does "enable the debtor to acquire rights in or the use of the collateral"; and for seller-obligees, the question becomes whether the negative equity was all or part of the price of the collateral. However, this distinction may be of little importance because courts and even the Code's official comments often do not distinguish between the two, implying that the result should be the same under either provision.

Comment 3 of U.C.C. § 9-103 elaborates on the definition and gives the following list of types of items that are included in either "price" of collateral or "value given to enable": "obligations for expenses incurred in connection with acquiring rights in the collateral, sales taxes, duties, finance charges, interest, freight charges, costs of storage in transit, demurrage, administrative charges, expenses of collection and enforcement, attorney's fees, and other similar obligations." This list is not exclusive, as the last item, "other similar obligations" indicates. Courts differ on whether negative equity is a "similar obligation."

154 Id. § 9-103(a)(1).
155 4 White & Summers, supra note 18, § 31-6(a), at 135 ("[A] third party...that lends money to a prospective buyer to assist the buyer in the purchase can...also qualify as a purchase money lender under section 9-103(a)(2). That person must make advances or incur an obligation 'to enable the debtor to acquire rights in or the use of collateral,' and, the money lent must be 'in fact so used.'" (footnote omitted)).
156 U.C.C. § 9-103(a)(2); see 4 White & Summers, supra note 18, § 31-6(a), at 135.
157 See, e.g., In re Graupner, 356 B.R. 907, 911-12 (Bankr. M.D. Ga. 2006) (focusing, in a case involving a seller-lender, on whether the obligation was incurred as all or part of the price of the collateral), aff'd sub nom. Graupner v. Nuvell Credit Corp., 537 F.3d 1295 (11th Cir. 2008).
158 See, e.g., Gen. Motors Acceptance Corp. v. Mancini (In re Mancini), 390 B.R. 796, 800-01 (Bankr. M.D. Pa. 2008) (failing to distinguish in the context of a third-party lender holding the security interest); U.C.C. § 9-103 cmt. 3 (failing to distinguish when providing a list of items that would be included and listing what "the 'price' of collateral or the 'value given to enable' includes").
159 U.C.C. § 9-103 cmt. 3.
160 See supra tbl.
The better-reasoned argument is that payment of the negative equity from the trade-in vehicle does not enable the debtor to acquire rights in or the use of the collateral. None of the listed obligations are related to prior transactions, unlike negative equity, which must originate in a prior transaction. While some courts have held that negative equity does "enable" the debtor to acquire rights in the collateral because the buyer could not make the purchase without the trade-in, the majority have held that negative equity does not "enable" the debtor to acquire rights in the collateral.\textsuperscript{161}

Because a PMSI does not secure the negative equity, the dual-status rule is the better approach.\textsuperscript{162} The drafters of Article 9 provided guidance in the non-consumer context through section 9-103(f)(1).\textsuperscript{163} The drafters, however, did not find the courage to give a rule for consumer transactions and adopted section 9-103(h) specifically disavowing any inference of application to that setting.\textsuperscript{164} The drafters' unwillingness to unsettle previous case law under prior Article 9 does not mean that applying the dual-status rule is any less preferential. The transformation rule results in very harsh treatment; even a tiny fraction of non-purchase-money obligation will cause the entire interest to lose purchase-money status.\textsuperscript{165} The majority of courts holding that negative equity is not a purchase-money obligation apply the dual-status rule.\textsuperscript{166} Courts should apply this rule, which is analogous to the business rule.

\textsuperscript{161} See id. However, one should note that there is a growing consensus among the federal circuit courts that a PMSI does secure negative equity. See, e.g., In re Price, 562 F.3d 618 (4th Cir. 2009); Ford v. Ford Motor Credit Corp. (In re Ford), 574 F.3d 1279 (10th Cir. 2009); In re Mierkowski, No. 08-3866, 2009 WL 2853586 (8th Cir. Sept. 8, 2009); In re Dale, No. 08-20583, 2009 WL 2857998 (5th Cir. Sept. 8, 2009); Graupner, 537 F.3d 1295. While these courts are interpreting state law, at least one of the circuits has articulated that given the uniform nature of the provisions, courts may give added weight to these decisions across state lines. See Ford, 574 F.3d at 1283 n.2 (noting the identical nature of the provisions being interpreted).

\textsuperscript{162} One should not consider the application to the Bankruptcy Abuse Prevention and Consumer Protection Act in determining choice of rule. See supra Part IV.C.

\textsuperscript{163} Although note that in the case of the negative equity from a loan held by the same financier, negative equity might retain purchase-money status. See U.C.C. § 9-103(f)(3).

\textsuperscript{164} Notice, however, that Idaho, Kansas, Maryland, and South Dakota have omitted the limiting language of U.C.C. § 9-103(h) from their versions of the U.C.C. See IDAHO CODE ANN. § 28-9-103 (2001); KAN. U.C.C. ANN. § 84-9-103 (West 2008); MD. CODE ANN., COM. LAW § 9-103 (LexisNexis 2002); S.D. CODIFIED LAWS § 57A-9-103 (2004).


\textsuperscript{166} See supra tbl.
E. Cleaning Up Its Own Mess—The Need for Congressional Action

It does not follow from the intent to apply state law that Congress anticipated or desired the resulting inconsistency. Unfortunately, as a number of courts have lamented,167 little legislative history is available.168 However, even from that limited history, what seems clear is that the purpose of the hanging paragraph was to aid creditors.169 Even if Congress intended such a variety of rules, the result is not aiding creditors due to difficulties in valuing loans. Therefore, whether one thinks that the aid to creditors was an appropriate or inappropriate goal, the hanging paragraph is aiding neither lenders nor borrowers.

At one point, this difficulty was not of great concern to taxpayers. Today, however, the stakes for the taxpayer—as a sixty-percent shareholder in the so-called “new” General Motors—are much higher.170 Taxpayers have contributed over fifty billion dollars to General Motors alone,171 and the government is unlikely to recoup much of the investment.172 This issue is of great concern to the taxpayer-shareholder because of the extent to which the industry has historically relied on its financing divisions for revenue.173

This situation presents Congress with an opportunity to reevaluate the wisdom of the hanging paragraph. Although some will likely argue that Congress should remove the hanging paragraph from the Bankruptcy Code, this would be a mistake. The government has invested $50 billion in General Motors, $34 billion in Chrysler, and $12.5 billion in GMAC.174 Allowing reckless borrowers to leave the

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168 See supra notes 149–51 and accompanying text.
169 See supra Part IV.C (discussing congressional intent regarding the hanging paragraph and supporting legislative history).
170 Peter Whoriskey, With Bankruptcy Behind It, GM Focuses on a Culture Change, Wash. Post, July 11, 2009 (“The U.S. Treasury owns 60.8 percent of the new company’s common stock . . . .”).
171 Id.
172 Christopher S. Rugaber, Taxpayers Face Heavy Losses on Auto Bailout, Sept. 9, 2009, available at http://www.greenchange.org/article.php?id=4914 (“The Congressional Oversight Panel did not provide an estimate of the projected loss . . . [. b]ut it said most of the $23 billion initially provided to General Motors Corp. and Chrysler LLC late last year is unlikely to be repaid.”).
173 See Carty, supra note 33. Note that in May the Treasury announced that it would swap $884 million of its preferred-stock investment in GMAC for common stock giving a 35.4% equity stake, a stake that could rise above 50% if more of those investments were converted later. See Aparajita Saha-Bubna & Dan Fitzpatrick, GMAC Says It Needs $1 Billion in Cost Cuts, WALL ST. J., May 23, 2009, at B5.
autmakers with these debts will merely transfer the crammed down amounts to the taxpayer. For these reasons, Congress should retain the anti-cram-down provisions in the revised legislation.

On the other hand, the problem of unwise borrowing, which both exposes the economy as a whole and the individual consumer to great risk, cautions against retaining the anti-cram-down provisions. A definition including negative equity would encourage lenders to continue to make these problematic "upside down" loans. Yet, a definition functioning like the transformation rule would be a windfall to unwise borrowers at the expense of lenders, other consumers, and even the taxpayer. An open definition functioning like the dual-status rule would run the risk of similar problems to the current definition regarding other items included in automotive loans such as gap insurance and extended warranties. Therefore, a solution that balances both these concerns and the prevention of transferring defaults for existing loans to the lenders and ultimately the taxpayers would be ideal.

To meet these goals, Congress should take a two-prong approach. For the first prong, regarding new loans, the best solution is a definition that provides an exclusive list of elements of the transaction that the statute will cover. This list should not include negative equity or other add-ons for protection from cram-down. Not including these items will reduce incentives for additional irresponsible lending. By providing an exclusive list of elements that the provision will cover, questions will not arise regarding whether another element, such as extended warranties, is covered. Since this list would not include negative equity and other add-ons, it should apply only to new loans.

For the second prong, regarding existing loans, a provision specifically including negative equity will prevent debtors from cramming down their loans and potentially passing the costs on to the taxpayer. Including negative equity will avoid a windfall to unwise borrowers by preventing cram-down of loans made under the expectation that the Code would not permit it. That expectation exists because such treatment more closely matches the language of the current statute, the original congressional intent, and the treatment of negative equity by the majority of courts. The combination of these two provisions will achieve the proper incentives and disincentives while avoiding exposing the taxpayer to greater risk on the investment in the automakers and their finance divisions.

Relief Program. See Bill Vlasic, U.S. Plans to Lend Chrysler $1.5 Billion for Auto Loans, N.Y. TIMES, Jan. 17, 2009, at B3. However, this loan has already been paid off. See Bennett & Haywood, supra.
CONCLUSION

The Bankruptcy Abuse Prevention and Consumer Protection Act made many changes to bankruptcy law. Regardless of one’s position on this legislation, the lack of consistency in the treatment of the anticom-ram-down provision is problematic. Clearly, Congress failed to appreciate the scope of problems associated with the use of the term “purchase-money security interest.” As a result, courts have reached a number of different results in applying state law. A number of these courts have incorrectly applied the Uniform Commercial Code, and others, in a well-intentioned effort to provide some uniformity to the treatment of these loans, have inappropriately applied federal law to determine the meaning of PMSI.

Congress and the courts have left lenders and borrowers with little or no guidance regarding how bankruptcy courts will treat negative equity in Chapter 13 cases. Whether one thinks the hanging paragraph was an appropriate way of “restoring the foundation of secured credit,” an unnecessary provision because the foundation of secured credit did not need restoration, or a giveaway to lenders who engage in abusive lending practices, its result in this area is clear.175 Congress has created the problem, and Congress should take the responsibility of cleaning it up. Congress can best clean up this mess by enacting a new provision providing a clear definition in keeping with the original Act for loans made under the current section 1325(a) and a new rule removing the hanging paragraph’s protection for negative equity financed in new loans. Such a rule will provide clarity and proper incentives for future loans and match what seems to have been the intent of the current version.

In the mean time, courts handling cases under the current law should apply state law. Under the Uniform Commercial Code, the best answer is that negative equity is not a purchase-money obligation, meaning that a PMSI does not secure that part of the obligation. Rather than applying the transformation rule, courts should apply the dual-status rule analogous to the rule for non-consumer transactions.

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175 Of course, a number of articles address both the benefits and problems of the Bankruptcy Abuse Prevention and Consumer Protection Act. This topic is outside of the scope of this Note; in order to focus on the hanging paragraph and solutions to the problems with the use of the term “purchase-money security interest,” the author offers no opinion on the subject.