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Whether Negative Equity is Part of Purchase Money Security Interest?

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The 2005 BAPCPA amendments have turned routine car purchases into a source of litigation in the federal courts. The litigation stems from the financing agreements made during the transaction. Today, these financing agreements often require the purchaser to repay loans over a term of five years or longer. *See, e.g. In re Peaslee*, 358 B.R. 545, 554 (Bankr. W.D.N.Y. 2006). During these long terms, cars rapidly depreciate in value. Consequently, many consumers are left with vehicles that have a market value less then the amount of debt still owed on them. This deficiency is called "negative equity." Often, consumers want to purchase new vehicles and trade-in their cars with negative equity. To encourage purchasing of new vehicles, car dealers finance the negative equity on the trade-in. These financing agreements usually lump together purchase money and negative equity into one loan creating a purchase-money security interest ("PMSI") in the vehicle. However, it is unclear whether the financing of negative equity is included as part of the PMSI under the bankruptcy code. This is an important issue because BAPCPA adopted a provision nicknamed the "hanging paragraph" found in 11 U.S.C. § 1325(a)(*) (2006). The hanging paragraph gives auto lenders extra protection in a bankruptcy proceeding. To get this extra protection, the creditors must have a PMSI in the vehicle. Hence, both creditors and debtors have litigated whether the bankruptcy code gives auto lenders a PMSI for financing negative equity. As a result of the litigation, courts around the country have taken three different approaches in deciding the issue.

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Overview of the Hanging Paragraph

The hanging paragraph was added to the bankruptcy code as part of the 2005 BAPCPA amendments, which were intended to curb consumer bankruptcy abuse. The provision is called the hanging paragraph because it is not designated by number, but just "hangs" as a subparagraph below 11 U.S.C. § 1325 (a)(9). *See Graupner v. Nuvell Credit Corp.* (In *re Graupner*), 537 F.3d 1295, 1296 at n. 1 (11th Cir. 2008). The hanging paragraph states that "[f]or purposes of 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 (as defined in section 30102 of title 49) 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." 11 U.S.C. § 1325(a)(*). This clause was made part of the bankruptcy code in order to prevent debtors from bifurcating automobile purchases made within two and half years before the filing of bankruptcy. Bifurcation is a tool, found in 11 U.S.C. § 506(a)(1) (2006) of the bankruptcy code, that benefits the debtor. Section 506 allows the court to divide the creditors security interest into secured and unsecured portions. However, it is unclear whether negative equity rolled into an automobile purchase is protected from bifurcation.

The hanging paragraph protects creditors from Section 506 (a)(1), which favors the debtor by bifurcating the obligation owed to the creditor. The statute provides "[a]n 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." § 506(a)(1). In other words, the creditor's claim would be divided into a secured interest for the value of the property and unsecured interest for the remainder of the amount owed. As a result, the creditor's original security interest for the entire amount of the obligation is reduced to the value of the collateral. Thus, bifurcation "crams down" the creditor's secured claim. *In re Graupner,* 537 F.3d at 1295.

Given that Congress viewed cramdown as abuse of the bankruptcy process, it added the hanging paragraph to the 2005 BAPCPA amendments. *Id*. at 1297. Congress's intent was to prevent creditors from purchasing vehicles on the eve of their bankruptcy filing and then using the cramdown provision to lower their obligation. *In re Payne*, 347 B.R. 278, 281 (Bankr S.D. Ohio. 2006). In order to prevent such exploitation, the hanging paragraph precludes Section 506 cramdown where 1) the creditor has a PMSI securing the debt; 2) the debt was incurred within 910 days before the filing of the debtor's bankruptcy petition; 3) the collateral for the debt consists of a motor vehicle; and 4) the motor vehicle was acquired for the personal use of the debtor. § 1325 (a)(*). However, application of the hanging paragraph has proven to be difficult.

Due to poor drafting, the hanging paragraph has created much disagreement among courts about the meaning of PSMI. PMSI is not defined in the bankruptcy code, leaving courts to speculate whether it includes negative equity or not. Despite similar fact patterns, courts have come to three different conclusions. First, the Eleventh Circuit in *In re Graupner*, 537 F.3d at 1301, held that negative equity is part of the PMSI and therefore is exempt from Section 506(a)(1) bifurcation. In *In re Munzberg*, 388 B.R. 529 (Bankr. D. Vt. 2008), the District of Vermont rejected the notion that negative equity is incorporated into the PMSI, choosing to use the "dual-status" approach that exempted the price of the car from cramdown but not negative equity. Finally, in *In re Sanders*, 377 B.R. 836 (Bankr. W.D. Tex. 2007) the District Court also

held that negative equity was not part of the PMSI, but chose to use the transformation rule instead of the dual-status approach. The transformation rule states that if even part of the loan is not PMSI, then the hanging paragraph does not apply at all. *Id*. at 546, n. 9. These courts all used statutory interpretation and policy considerations to achieve very different results.

A Pro-Lender Approach

As the highest court to date to render a decision on the issue, the Eleventh Circuit in *In re Graupner* held the entire loan amount was free from the cramdown provision in Section 506(a)(1). 537 F.3d at 1302. The court came to this conclusion from a simple set of facts. The debtor purchased a new vehicle for personal use less then 910 days before the filing of bankruptcy. *Id*. at 1298. The vehicle had a cash price of $32,919.12. *Id*. In addition to buying the car, the debtor also traded in a used vehicle that had $6,357 more debt on it then the vehicle was worth. *Id*. The creditor took the trade-in and rolled the negative equity into the price of the contract. As a result, the debtor owed $36,384.62 on the final retail installment contract. *Id*. The inclusion of negative equity became an issue during the bankruptcy proceeding. At issue, was whether negative equity is included in PMSI, giving the creditor protection from cramdown under the hanging paragraph. The bankruptcy court held that negative equity is included. *In re Graupner*, 356 B.R. 907, 917 (Bankr. M.D. Ga. 2006). As a result, the creditor retained a security interest for the entire value of the contract. The district court affirmed that decision. *In re Graupner*, 537 F.3d at 1300.

After a careful review of both state law and congressional intent, the Eleventh Circuit Court of Appeals upheld the decision. The court used Georgia's state version of Article 9 of the UCC and the Motor Vehicle Sales Finance Act ("MVSFA") to render it's decision. *Id*. at 1301.

First, the court defined PMSI. A creditor has a PMSI "[to] the extent that the goods are purchase-money collateral with respect to that security interest." Ga. Code Ann., § 11-9-103. The statute then defines purchase-money collateral as "goods or software that secure a purchase-money obligation with respect to that collateral." *Id.* Finally, the statute defines a purchase-money obligation as "an obligation by an obligor incurred as all or part of the price of the collateral or for the value given to enable the debtor to acquire rights in use of the collateral if the value is in fact so used." *Id*. Simply put, PMSI is where the creditor has a security interest in collateral for the dollar amount needed to purchase that collateral. That amount is determined by the "price of the collateral or value given to enable." Thus, the court's next step was to determine whether "price of the collateral or value given to enable" includes negative equity.

The court turned to Comment 3 in U.C.C. § 9-103 for guidance. The comment lists various expenses, such as sales taxes, duties, finance charges, interest, freight charges, etc., that are considered part of the price of collateral. Though the list does not include negative equity, the court concluded that the list is not exhaustive. The court reasoned that negative equity is analogous to the listed items because it is an expense necessary for the debtor to purchase the vehicle, hereby making it part of the price of collateral. *In re Graupner*, 537 F.3d at 1302. Furthermore, the court noted that "Comment 3 states that PMSI 'requires a close nexus between the acquisition of collateral and the secured obligation,'" and held such a nexus exists because refinancing negative equity and purchasing the vehicle are part of one transaction necessary for the debtor to "drive the car off the lot." *Id*. Finally, the court upheld the bankruptcy court's use of the MSFVA *in pari materia* with Georgia's version of the U.C.C. *Id*. at 1301. In the MSFVA, "cash sale price" includes money paid to satisfy a lien on a trade-in vehicle in the retail installment contract. The court noted that the MSFVA's definition gives further confirmation

that negative equity is part of the price necessary to purchase the collateral. Thus, after careful analysis of state law, the court held that negative equity is included in PMSI.

The court used legislative intent to further support its conclusion. The court, explained that one goal of this legislation was to give additional protection to secured creditors, specifically automobile lenders. *In re Dunlap*, 383 B.R. 113, 118 (Bankr. E.D. Wis. 2008). More specifically, the court made clear that the hanging paragraph was created to prevent abuse by debtors purchasing a vehicle within 910 days of filing for bankruptcy. The court noted, it is likely that many debtors trade in vehicles with negative equity because 29 to 38 percent of car purchases, in general, involve such transactions. *In re Graupner*, 537 F.3d at 1303 (citing *In re Pajot*, 371 B.R. 139, 153 at n. 17). Since having negative equity on a trade-in vehicle was already common when BAPCPA was enacted, the court found it logical that Congress would address the issue. With such a high volume of purchases having negative equity in the contract, the court held it unreasonable that Congress would exclude such a substantial part of the market from the hanging paragraph. *Id*. The court stressed that statutes should not be interpreted in a way that would produce an "absurd" result when compared to the purpose of the legislation. *Id*. The court held that if negative equity were not considered part of PMSI, the result would be exactly that.

A Compromise

Faced with similar facts, the court in *In re Munzberg* came to the opposite conclusion. The circumstances in *In re Graupner* and *In re Munzberg* were almost identical. Once again, the debtor purchased a new car from the creditor and traded in a vehicle with negative equity as part of a retail installment contract. *In re Munzberg*, 388 B.R. at 533. The purchase was for a vehicle,

within 910 days of filing for bankruptcy, and was for the debtor's personal use. *Id.* During the bankruptcy proceeding, the debtor introduced a repayment plan that the creditor rejected. *Id.* at 534. The parties disagreed about whether negative equity is included in PMSI. Again the court turned to state law and Congressional intent to solve this question. Concluding that negative equity is not part of PMSI, the court posited how to treat the debtor's obligations to the creditor.

The court first turned to Vermont's version of the U.C.C. Just like Georgia, Vermont had adopted a state statue virtually identical to U.C.C. § 9-103. Thus, the court had to yet again decide whether negative equity is part of the "price of collateral or value given to enable" in the definition of purchase-money obligation. *Id.* at 537. Turning to Official Comment 3's two-part test, the court concluded it is not. First, the court determined if negative equity is similar to the list of expenses in Comment 3 that are considered part of the price of collateral. For guidance, the court looked to Comment 2 in U.C.C. § 9-107, the precursor to U.C.C. § 9-103, which provided that PMSI cannot secure antecedent debt. *Id.* at 539. The court stated that negative equity is antecedent debt because it is used to purchase a previous car, not the one at issue in the bankruptcy proceeding. *Id.* Therefore, according to Comment 2, negative equity is not PMSI. *Id.* Since the meaning of PMSI has not changed, making Comment 2 still applicable, the court held that negative equity is not included in the list of expenses that are part of PMSI . *Id.* Next the court held that negative equity does not have a "close nexus between the acquisition of the collateral and the secured obligation." Id. at 540. The court reasoned that negative equity is in relation to the purchase of the first vehicle and is actually unsecured debt. *Id.* The court determined that the debt is unsecured because negative equity is equal to the deficiency of the original debt on the first vehicle, had the first creditor foreclosed. *In re Pajot*, 371 B.R. 139, 154 (Bankr. E.D. Va. 2007). Since deficiencies are unsecured, the second creditor, who financed the

negative equity, is simply paying off the original creditor's unsecured debt. *Id*. Therefore, the court held that paying off a debtor's antecedent debt does not have a close nexus to acquiring the new car.

The court then looked to the state's retail installment financing act and Congressional intent to further it's argument. Unlike in *In re Graupner*, the court refused to read the Motor Vehicle Retail Installment Sales Financing Act (MVRISFA), similar to the MVSFA in Georgia, *in pari materia* with the U.C.C. *In re Munzberg*, 388 B.R. at 542. The court explained that the purpose of Article 9 in the U.C.C. is to create security interests, while the MVRISFA is a disclosure statute made to protect consumers. *Id*. Since these statutes have different purposes, the court held they cannot be read *in pari materia.* *Id*. at 543. Finally, the court examined congressional intent to reach its decision. The court conceded that BAPCPA was made to protect creditors from abuse of the bankruptcy code. *Id*. at 54. However, the court added that nothing in the legislative history suggests that Congress gave power to automobile lenders to convert unsecured debt, negative equity in this case, into a PMSI. *Id*. Hence, the court held that nothing in the MSFVA or BAPCPA's legislative history suggest negative equity should be part of PMSI.

After determining negative equity is not PMSI, the court chose to split the obligation into PMSI and non-PMSI. The UCC gives the court discretion to split consumer goods purchases into different types of debt. *Id*. at 545 (citing 9A V.S.A. § 9-103(h) comment 8). The court began its analysis of this issue by examining Section 9-103 which provides "that a security interest is PMSI "*to the extent* that goods are purchase-money collateral."' *Id*. at 546. The court stated that the phrase, to the extent, suggests collateral can secure more then just the purchase price, and still keep its purchase-money character. *Id*. Thus the court concluded that a single loan can

contain both a PMSI and a regular security interest. Next, the court studied the legislative history of the hanging paragraph. It noted that the legislative history suggests that Congress intended to help auto lenders. *Id*. at 545. If negative equity transformed the entire debt into a regular security interest, the auto lenders would not benefit from the hanging paragraph any time negative equity was rolled into the purchase. Therefore, the court found it unlikely that Congress intended creditors to be completely precluded from the protection of the hanging paragraph as a result of refinancing the debtor's trade-in vehicle. With that in mind, the court chose to use the dual- status rule. As a result, the portion that was PMSI retained it's status, while the debt that was non-PMSI was subject to bifurcation. Consequently, the negative equity in this case was crameddown under Section 506(a), while the rest of the debt was protected under the hanging paragraph.

A Debtor-Friendly Court

In what appears to be a more extreme approach to this line of cases, *In re Sanders* applied the transformation rule. The court used the transformation rule after once again analyzing whether negative equity is part of PMSI. The analysis was prompted after the debtor filed a petition that involved facts almost identical to *In re Graupner* and *In re Munzberg*. The debtor purchased a new vehicle by obtaining financing from the car dealer. *In re Sanders*, 377 B.R. at 840. The financing paid off the negative equity on the debtor's trade-in vehicle. Less then 910 days after the purchase of the new car, the debtor filed for bankruptcy relief. *Id*. During the bankruptcy confirmation hearing, both parties argued whether the transaction constituted a PMSI. *Id*. at 841

The court analyzed the UCC's definition of PMSI by using statutory construction and

comparable state law. As in the previous cases, the court narrowed the issue to whether negative equity should be considered "price of collateral or value given to enable" in the definition of purchase-money obligation under Tex. Bus. & Comm. Code § 9.103, Texas's version of the U.C.C. The court defined price by reading Section 9.103 and the Tex. Fin. Code. § 348.008 (2006) *in pari materia*. *Id*. at 847. Upon reading Section 348.008, the court noted that the statute includes negative equity in the "principle balance" of the contract but not in the "cash sales price." *Id*. at 850. The court explained that since "price of collateral" is more equated with "cash sales price" then with "principal balance," negative equity should not be part of the U.C.C.'s definition of purchase-money collateral. *Id*. at 851. The court then considered the construction of Section 9.103. Statutory construction requires "courts … to be governed by rules of common sense." *Id*. at 851 (citing In re Ambers Stores, Inc., 205 B.R. 828 (Bankr. N.D. Tex. 1997). Using this cannon, the court found it unreasonable to conclude that financing antecedent debt is considered part of the price of the car itself. *Id*. at 852. The court stated that where money is used to buy the car and money is used for something else, the money used to buy the car is part of the purchase-money obligation. *Id*. at 853. Thus, negative equity is not part of purchase-money obligation within the meaning of PMSI and as a result not PMSI.

After finding negative equity is not part of PMSI, the court used the transformation rule. The transformation rule gives the creditor no protection under the hanging paragraph. To reach this conclusion, the court looked to the plain meaning of the hanging paragraph. *Id*. at 858. The court stated that the hanging paragraph gives a specific group of lenders protection from the Section 506(a). The court further noted that Section 506(a) generally applies to most other lenders. Thus, the court held that the hanging paragraph should be construed narrowly in accordance with the maxim that "[e]xceptions to general rules are construed narrowly." *Id*. at

859 (citing Scarborough v. Chase Manhattan Mortgage, 461 F.3d 406, 410 (3d Cir. 2006). Here, the hanging paragraph gives protection *if* the *debt* is PMSI. The court treated "if" as a conditional term. Id. at 860. Furthermore, the court found the term "debt" to be synonymous with the term "claim." Id. Hence, the court held that since "claim" in the hanging paragraph is used as the whole claim, then "debt" should be considered the whole debt. *Id*. In other words, the creditor only gets protection from cramdown *if* the *whole debt* is part of PMSI. The court discussed that if debt was not meant to be defined as the whole debt, Congress would have used language such as *to the extent of* or *part of* the debt. *Id*. at 859. Since Congress did not use such terms, the court inferred the omission was done intentionally. As a result, Congress intended debt that includes non-PMSI to not fall within the hanging paragraph.

Conclusion

As it stands today, litigation on the hanging paragraph is not determined by any uniform reasoning, but by what jurisdiction that litigation happens to occur. The only existing consistency among the courts is that the definition of PMSI is found somewhere in each state's version of U.C.C. § 9-103. Nonetheless, *In re Graupner* was a big step towards a consensus. It is the highest court to make a decision. Thus, the multitude of decisions within the 11nth circuit are now resolved. In addition, the 2nd circuit in *In re Peaslee* has recently sent the case to the New York Court of Appeals for certification on the definition of PMSI. 547 F.3d 177 (2d Cir. 2008) After the Court of Appeals renders a decision, another circuit will have clarity on the issue. In the mean time, attorneys must look to case law in their jurisdiction to determine which of the three current approaches their judge may adopt. Nonetheless, *In re Graupner* is a sign of trouble for debtors.

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