



1    MARKELL, Bankruptcy Judge:

2    **I.    Introduction**

3           This appeal presents a pure question of law: When a debtor  
4    trades in a motor vehicle in connection with buying a new one,  
5    and the lender who is financing the purchase assumes the debtor's  
6    "negative equity" on the trade-in, how should the transaction be  
7    treated under the troublesome "hanging paragraph" of § 1325(a) of  
8    the Bankruptcy Code?

9           As an initial matter, we ask whether the lender's payoff of  
10   the deficiency on the trade-in is secured by a purchase money  
11   security interest in the new car, which would make it protected  
12   by the hanging paragraph. Borrowing and applying rules from the  
13   Uniform Commercial Code (UCC), we hold that it is not.

14          That leaves the question of what to do with that portion of  
15   the debt not entitled to purchase-money status. Courts that have  
16   looked at this question have followed two different lines of  
17   reasoning with two different outcomes. For the reasons discussed  
18   below, we believe one of them, the so-called "Dual Status Rule"  
19   fits federal law better than the other, the so-called  
20   "Transformation Rule." We thus hold that the hanging paragraph  
21   protects that portion of the lender's debt allocable to the car  
22   purchased, and does not protect that portion of the debt that is  
23   allocable to negative equity.

24          The bankruptcy court in this case reached the same  
25   conclusion, and we therefore AFFIRM.

26    **II.   Facts**

27          On September 12, 2005, Marlene Penrod bought a 2005 Ford  
28   Taurus from Hansel Ford in Santa Rosa, California. The cash

1 price of the car was approximately \$23,500,<sup>1</sup> and with tax and  
2 license, the total amount that a cash buyer would have paid for  
3 the Taurus was \$25,600. To finance the purchase, Penrod paid  
4 \$1,000 down and traded in her 1999 Ford Explorer. The dealership  
5 gave her \$6,000 in credit for the Explorer, on which she owed  
6 \$13,137.42. The \$7,137.42 difference is what is referred to as  
7 "negative equity" in the business of motor vehicle sales finance.

8 Hansel agreed to pay off the entire amount owed on the  
9 Explorer and add the negative equity to the amount Penrod  
10 financed.<sup>2</sup> As a result, the total amount financed appears to  
11 have been approximately \$31,700. Shortly after the sale, Hansel  
12 assigned Penrod's contract to appellant Americredit Financial  
13 Services, Inc.<sup>3</sup>

14 Penrod filed a chapter 13 bankruptcy on March 2, 2007, which  
15 was 523 days after she bought the Taurus. As of the filing, the  
16 bankruptcy court found that the total amount of the debt secured  
17 by the car was \$25,675, which included the negative equity.

18 Penrod initially proposed a chapter 13 plan that valued the  
19 Taurus at \$15,615 (its then-Kelly Blue Book value). The plan  
20 reduced Americredit's secured claim to that amount, and it also  
21 reduced the rate of interest applicable to that secured debt to  
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23  
24 <sup>1</sup> We use round numbers for convenience.

25 <sup>2</sup> Penrod also agreed to pay interest at an annual rate of  
26 20%.

27 <sup>3</sup> For purposes of this appeal, we treat Americredit and  
28 Hansel as the same, as there is no issue that the assignment  
affected or altered any rights. See Trejos v. VW Credit, Inc.  
(In re Trejos), 374 B.R. 210 (9th Cir. BAP 2007).

1 9%.<sup>4</sup> Americredit objected, claiming that the entire amount of  
2 its claim was protected by the so-called "hanging paragraph" of  
3 § 1325(a), and, thus, the debtor could not cram down its secured  
4 claim to the car's value.

5 After supplemental briefing, the bankruptcy court ruled  
6 that, to the extent that Americredit's security interest in the  
7 Taurus secured Penrod's negative equity, it was not a purchase  
8 money security interest.<sup>5</sup> But the court also held that the  
9 remaining balance – some \$18,540 – was secured by a purchase  
10 money security interest.<sup>6</sup>

11 In finding that a portion of Americredit's claim was still  
12 secured by a purchase money security interest, the bankruptcy  
13 court rejected Penrod's assertion that the "Transformation Rule"  
14 rendered the entire security interest nonpurchase money. It also  
15 rejected Americredit's assertion that the negative equity was  
16 irrelevant to the purchase money characterization.

17 The bankruptcy court adopted the "Dual Status Rule" from  
18 state law, holding that a security interest may be simultaneously  
19 characterized as purchase money and nonpurchase money depending  
20 on the nature of the debt it secures. Seven days after its

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21  
22 <sup>4</sup> The bankruptcy court relied on Till v. SCS Credit Corp.,  
23 541 U.S. 465 (2004) in reducing the rate. Americredit has not  
challenged this reduction on appeal.

24 <sup>5</sup> As a result of preliminary versions of these rulings,  
25 Penrod filed a second amended chapter 13 plan, which increased  
26 the amount of Americredit's secured claim to \$18,540 – the  
difference between the amount of the secured claim under  
nonbankruptcy law and the amount of the negative equity.

27 <sup>6</sup> The court did not allocate any of the payments that  
28 Penrod made to the negative equity portion of Americredit's  
claim. Americredit has not challenged this allocation on appeal.

1 ruling on the purchase money status of Americredit's security  
2 interest, the bankruptcy court confirmed Penrod's second amended  
3 chapter 13 plan.

4 Americredit has appealed both the order finding that its  
5 security interest was only partially purchase money and the order  
6 confirming Penrod's chapter 13 plan.

### 7 **III. Jurisdiction**

8 The bankruptcy court had jurisdiction under 28 U.S.C.  
9 § 1334(a), the general order of reference for the Northern  
10 District of California, and 28 U.S.C. § 157(b)(2)(A), (B) & (L).  
11 We have jurisdiction under 28 U.S.C. § 158.

### 12 **IV. Standards of Review**

13 "[I]ssues of statutory construction and conclusions of law,  
14 including interpretation of provisions of the Bankruptcy Code,"  
15 are reviewed de novo. Mendez v. Salven (In re Mendez), 367 B.R.  
16 109, 113 (9th Cir. BAP 2007) (citing Einstein/Noah Bagel Corp. v.  
17 Smith (In re BCE W., L.P.), 319 F.3d 1166, 1170 (9th Cir. 2003)).  
18 See also Trejos v. VW Credit, Inc. (In re Trejos), 374 B.R. 210,  
19 214 (9th Cir. BAP 2007) (interpretation of § 1325(a)'s "hanging  
20 paragraph" reviewed de novo).

1 **V. Discussion**

2 Although much has been written on the issues presented, most  
3 of the opinions have been in bankruptcy courts, with a few  
4 district court appellate decisions appearing occasionally. No  
5 circuit, including the Ninth, has addressed these issues  
6 squarely, and we are not aware of any other Bankruptcy Appellate  
7 Panel decision on point. Accordingly, we start our analysis with  
8 some basic propositions.

9 In bankruptcy, secured claims normally do not exceed the  
10 value of the collateral. 11 U.S.C. § 506(a)(1). Shortfalls  
11 between claim amount and collateral value are treated as  
12 unsecured claims. Id. Before 2005, this feature of the law  
13 allowed many chapter 13 debtors to "cram down" claims secured by  
14 cars, since cars typically are worth less than the financing  
15 against them. This treatment mirrored what the creditor could  
16 expect outside of bankruptcy: a secured claim equal to the car's  
17 value and an unsecured deficiency for the balance. The principal  
18 differences in bankruptcy were: (1) that while the secured claim  
19 had to be paid in full during the life of the plan, the debtor  
20 received a discharge at the end of the plan for any unpaid  
21 portion of the car lender's deficiency; and (2) that the debtor  
22 was able to readjust the interest rate to a market rate of  
23 interest.

24 For certain types of car loans, this treatment changed  
25 radically after the 2005 amendments to the Code. For those  
26 claims covered by the so-called "hanging paragraph," car lenders'  
27 secured claims were no longer limited by the car's value. The  
28 hanging paragraph essentially gives covered car lenders a secured

1 claim for the entire amount of their claim, regardless of the  
2 car's value.

3 The application of these changes to this case is  
4 straightforward. Penrod's Taurus was worth approximately \$15,615  
5 at the start of the case; the amount owed to Americredit was  
6 \$25,675. Penrod's initial plan assumed that the hanging  
7 paragraph did not apply and proposed to cram down Americredit's  
8 claim to \$15,615 (the car's value), pay that amount over the life  
9 of the plan at 9% interest, and classify the remainder - some  
10 \$10,080 - as an unsecured claim.

11 Americredit's response asserted that the hanging paragraph  
12 applied to its entire claim of \$25,765. On this view, this  
13 higher amount would have to be paid over the plan's life.

14 The bankruptcy court found that the portion of the secured  
15 claim attributable to negative equity - some \$7,100 - was not  
16 governed by the hanging paragraph but that the remainder of  
17 Americredit's claim was. Accordingly, it found that Americredit  
18 had a secured claim of \$18,625 and an unsecured claim of \$7,100.  
19 Based on those valuations, the bankruptcy court confirmed  
20 Penrod's plan.

21 **A. The Hanging Paragraph**

22 The "hanging paragraph" is found somewhere around  
23 § 1325(a).<sup>7</sup> It provides:

24 \_\_\_\_\_  
25 <sup>7</sup> Congress did not specify exactly where in § 1325(a) to  
26 put the hanging paragraph. The preamble to the section that  
27 contained the statutory text simply stated that:

28 (b) RESTORING THE FOUNDATION FOR SECURED CREDIT.—  
Section 1325(a) of title 11, United States Code, is  
(continued...)

1 For purposes of paragraph (5), section 506 shall not  
2 apply to a claim described in that paragraph if the  
3 creditor has a purchase money security interest  
4 securing the debt that is the subject of the claim, the  
5 debt was incurred within the 910-day [sic] preceding  
6 the date of the filing of the petition, and the  
7 collateral for that debt consists of a motor vehicle  
8 (as defined in section 30102 of title 49) acquired for  
9 the personal use of the debtor, . . . .

6 Because of its odd placement in the statute as enacted, this  
7 text has no clear home in § 1325(a), and thus has been referred  
8 to as the "hanging paragraph," which is the designation this  
9 opinion will use.<sup>8</sup>

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12 <sup>7</sup>(...continued)  
13 amended by adding at the end the following: . . . .

14 Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,  
15 Pub. L. 109-8, § 306(b), 119 Stat. 23, 80 (2005).

16 The text that follows in the legislation, set forth in the  
17 body of this opinion, is not indented, and the usual guides to  
18 placement are not present, leaving the reader to wonder whether  
19 it should be a new paragraph or a continuation of the last part  
20 of paragraph (9) of § 1325(a). Different services initially  
21 treated the placement of this statutory language in different  
22 ways. Cf. MINI•CODE, SPECIAL REDLINED EDITION 209 (April, 2005 ed.,  
23 AWHFY, L.P., Publishers 2005) (no new paragraph; continuation of  
24 paragraph (9)); COLLIER PORTABLE PAMPHLET, 2005 SUPPLEMENT 423  
25 (LexisNexis Publishers 2005) (separate new paragraph appearing  
26 after conclusion of paragraph (9)).

27 The current version of the United States Code places the  
28 hanging paragraph as a separate textual paragraph following  
paragraph (9)). 11 U.S.C § 1325 (2006).

24 <sup>8</sup> Some courts have taken to referring to this statutory  
25 addition as the "starred" paragraph, as has Americredit. See,  
26 e.g., In re Ford, 387 B.R. 827, 2008 WL 2095677, at \*1 (Bankr. D.  
27 Kan. 2008); Triad Fin. Corp. v. Brown (In re Brown), 346 B.R.  
28 246, 249 n.1 (Bankr. M.D. Ga. 2006). While this usage has merit,  
it makes it more difficult to electronically search opinions that  
use this designation because electronic services such as Lexis  
and Westlaw use the asterisk ("\*"), the symbol commonly used to  
represent the star, as a universal search character.



1 We have previously interpreted this provision. In re  
2 Trejos, 374 B.R. at 214-21. In Trejos, we held that the hanging  
3 paragraph applies to secured claims in chapter 13, rejecting the  
4 contention that its wording removed the statutory basis for  
5 treating such claims as "allowed secured claims" under § 1325(a).  
6 Id. at 217-18.<sup>9</sup>

7 1. *Hanging Paragraph's Requirements*

8 To receive the treatment mandated by the hanging paragraph,  
9 certain conditions must be satisfied. These conditions are as  
10 follows:

- 11 • The creditor must have a purchase money security  
12 interest; and
- 13 • The purchase money security interest must secure the  
14 debt that is the subject of the claim; and
- 15 • That debt must be incurred no more than 910 days before  
16 the date of the debtor's filing; and
- 17 • The collateral for the debt must be a "motor vehicle;"  
18 and
- 19 • That motor vehicle must have been acquired for the  
20 personal use of the debtor.

21 In re Trejos, 374 B.R. at 215.

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24 <sup>9</sup> Not addressed in Trejos was the effect of the hanging  
25 paragraph on the modification of the applicable interest rate  
26 under § 1325(a)(5) to produce a stream of payments on the allowed  
27 secured claim equal to its present value. Since Americredit has  
28 not raised the issue in this appeal, we do not consider it. As  
noted in Trejos, "we save it for another day." 374 B.R. at 220  
n.9. Cf. Drive Fin. Servs., L.P. v. Jordan, 521 F.3d 343, 349-50  
(5th Cir. 2008) (Till remains good law after enactment of the  
hanging paragraph).

1           The parties dispute only that Americredit has a "purchase  
2 money security interest." In short, the parties have either  
3 stipulated or conceded: that Penrod's Taurus secures the claim at  
4 issue; that she purchased it within 910 days of her chapter 13  
5 filing; the Taurus is a "motor vehicle" within the meaning of 49  
6 U.S.C. § 30102;<sup>10</sup> and that Penrod's use of the Taurus is  
7 personal.

8           The remaining issue then, to use the words of the statute,  
9 is whether Americredit "has a purchase money security interest  
10 securing the debt that is the subject of the claim." Here, the  
11 parties diverge. Penrod contends that the financing of the  
12 negative equity was not part of the purchase money security  
13 interest. Americredit disagrees.

## 14           2.    *Definition and Role of "Negative Equity"*

15           Much ink has been spilled over the proper characterization  
16 and treatment of negative equity in secured claims subject to the  
17 hanging paragraph. Before sorting through the various analyses,  
18 however, it is appropriate to state exactly what is being  
19 discussed.

### 20           a.    *What Is It?*

21           Negative equity arises when a consumer trades in a car that  
22 is "under water" - a car that has more debt against it than it is  
23 worth - and the new seller rolls the deficiency on the old car  
24 into the debt on the new. An example illustrates the point.  
25 Assume that the debtor buys a new car. Dealer takes the old car

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27           <sup>10</sup> 49 U.S.C. 30102(a)(6) states that "'motor vehicle' means  
28 a vehicle driven or drawn by mechanical power and manufactured  
primarily for use on public streets, roads, and highways, but  
does not include a vehicle operated only on a rail line."

1 in trade for \$10,000, but the trade-in car has \$15,000 in debt  
2 against it. The \$5,000 deficiency, or the "negative equity," is  
3 rolled into the debt secured by new car.

4 In this case, Penrod traded in a car for which she received  
5 \$6,000 in credit, but that had more than \$13,100 in debt against  
6 it. The \$7,100 difference is the negative equity.

7 Negative equity is a substantial and recurring issue. A  
8 leading car lender, General Motors Acceptance Corporation, has  
9 stated in defending a similar claim that between 26% and 38% of  
10 all its new car financing involves "negative equity." In re  
11 Peaslee, 358 B.R. 545, 554 (Bankr. W.D.N.Y. 2006) ("Peaslee I").  
12 See also BARKLEY CLARK & BARBARA CLARK, SECURED TRANSACTIONS UNDER THE  
13 UNIFORM COMMERCIAL CODE ¶ 12.05[10][b] & n.17 (rev. ed. 2007)  
14 (listing same range, and quoting J.D. Powers & Associates study).

15 There is much unease about the proper treatment of negative  
16 equity under the hanging paragraph. Part of this unease is that  
17 "negative equity" is a term not unlike "deferred maintenance";  
18 that is, it seems to be an oxymoron at war with itself. Equity  
19 in property usually is a positive amount and represents an  
20 accumulation of wealth available to the property's owner. The  
21 use of the term "negative" equity cuts against that notion.

22 Another part of the unease is that the amount represented by  
23 negative equity is essentially another creditor's unsecured  
24 claim. When Penrod traded in her Explorer, she owed \$7,100 more  
25 to the entity that financed that vehicle than it was worth. Had  
26 she defaulted on the loan to that lender, the amount represented  
27 by negative equity would have been no more than a general  
28 unsecured claim against Penrod. Bankruptcy has a long history of

1 distrust of the conversion of unsecured claims into secured  
2 claims, e.g., Dean v. Davis, 242 U.S. 438 (1917) (substituting  
3 secured debt for unsecured debt held to be an intentional  
4 fraudulent conveyance). That distrust also presents itself here.

5           b. *What Turns on the Characterization?*

6           Besides this general unease, the stakes are potentially  
7 high. To confirm a chapter 13 plan, a debtor must provide for  
8 payment in full of all secured claims. 11 U.S.C. § 1325(a)(5).  
9 Unsecured claims, however, need only be paid their aliquot  
10 portion of the debtor's disposable income over the life of the  
11 plan. 11 U.S.C. § 1325(b)(1). The effect of finding that  
12 negative equity is secured by a purchase money security interest  
13 would be the transformation of all debt secured by the car -  
14 regardless of whether it is effectively secured or unsecured - to  
15 secured debt, with all its attendant feasibility and other issues  
16 related to plan confirmation. In the larger scheme of things,  
17 this is generally not an issue about whether the debtor retains  
18 more of his or her disposable income at the expense of creditors.  
19 Rather, it is an intercreditor issue: whether car lenders who  
20 fit within the "hanging paragraph" will receive more of a  
21 debtor's disposable income than the debtor's general unsecured  
22 creditors.

23           **B. *What Is A "Purchase Money Security Interest" Under the***  
24           ***Hanging Paragraph?***

25           The concept of a purchase money security interest or lien  
26 has had a long and venerable history in commercial law. See 2  
27 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 28.1, 745 n.3  
28 (1965) (tracing concept to 1631 and to Coke's Commentaries on

1 Littleton). Its origin in real estate law continues today and is  
2 reflected in various statutory schemes, such as those in effect  
3 in California. See, e.g., CAL. CODE CIV. PRO. 580b (precluding  
4 purchase money lenders and vendors on real estate from obtaining  
5 a deficiency judgment against the borrower after foreclosure).  
6 See Spangler v. Memel, 7 Cal.3d 603, 610, 498 P.2d 1055, 1059, 102  
7 Cal. Rptr. 807, 811 (Cal. 1972) (stating that “the standard  
8 purchase money mortgage transaction [is one] in which the vendor  
9 of real property retains an interest in the land sold to secure  
10 payment of part of the purchase price.”) (quoting Roseleaf Corp.  
11 v. Chierighino, 59 Cal.2d 35, 41, 378 P.2d 97, 100, 27 Cal. Rptr.  
12 873, 876 (Cal. 1963)); Union Bank v. Anderson, 232 Cal. App. 3d  
13 941, 946, 283 Cal. Rptr. 823, 826 (Cal. App. Ct. 1991) (same).

14 Purchase money financing concepts also hold a central place  
15 in the law of personal property security. Article 9 of the UCC,  
16 as revised in 1999 and generally effective in all states on July  
17 1, 2001 (“UCC”), devotes an entire section to it, UCC § 9-103,  
18 and there is a substantial body of case law devoted to its  
19 intricacies. See, e.g., CLARK & CLARK, supra, at ¶ 3.09; JAMES J.  
20 WHITE & ROBERT SUMMERS, UNIFORM COMMERCIAL CODE §§ 31-6 & 33-5 (5th ed.  
21 2002).

#### 22 1. *What Law Defines It?*

23 This background heightens the importance of how to define a  
24 purchase money security interest (variously, “PMSI”) for purposes  
25 of the hanging paragraph. When Congress enacted the hanging  
26 paragraph in 2005, it did not include a definition of a PMSI.  
27 That is not unusual; the 1978 Code had previously used the term  
28 without an explicit definition, and courts freely borrowed from

1 the UCC when interpreting the provisions that contained "purchase  
2 money security interest." See, e.g., Pristas v. Landaus of  
3 Plymouth, Inc. (In re Pristas), 742 F.2d 797, 800 (3d Cir. 1984)  
4 (11 U.S.C. § 522(f)); In re Donald, 343 B.R. 524, 536-37 (Bankr.  
5 E.D.N.C. 2006) (11 U.S.C. § 522(f) and hanging paragraph, dicta);  
6 In re Pan Am. Corp., 125 B.R. 372, 376 (S.D.N.Y.), aff'd, 929  
7 F.2d 109 (2d Cir.), cert. denied, 500 U.S. 946 (1991) (former 11  
8 U.S.C. § 1110); H.R. REP. No. 595, 95TH CONG., 1ST SESS. 240 (1977)  
9 (former 11 U.S.C. § 1110).

10 This borrowing has generally followed the Supreme Court's  
11 standard for incorporating state law understandings into  
12 federally defined terms:

13 Our cases indicate that a court should endeavor to fill  
14 the interstices of federal remedial schemes with  
15 uniform federal rules only when the scheme in question  
16 evidences a distinct need for nationwide legal  
17 standards, see, e.g. Clearfield Trust Co. v. United  
18 States, 318 U.S. 363, 366-367, 63 S.Ct. 573, 574-575,  
19 87 L.Ed. 838 (1943), or when express provisions in  
20 analogous statutory schemes embody congressional policy  
21 choices readily applicable to the matter at hand. See,  
22 e.g., Boyle v. United Technologies Corp., 487 U.S. 500,  
23 511-512, 108 S.Ct. 2510, 2518-2519, 101 L.Ed.2d 442  
(1988); DelCostello v. Teamsters, 462 U.S. 151,  
169-172, 103 S.Ct. 2281, 2293-2295, 76 L.Ed.2d 476  
(1983). Otherwise, we have indicated that federal  
20 courts should "incorporat[e] [state law] as the federal  
21 rule of decision," unless "application of [the  
22 particular] state law [in question] would frustrate  
23 specific objectives of the federal programs." United  
States v. Kimbell Foods, Inc., 440 U.S. 715, 728, 99  
S.Ct. 1448, 1458, 59 L.Ed.2d 711 (1979).

24 Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 98 (1991);  
25 Dzikowski v. N. Trust Bank of Fla. (In re Prudential of Fla.  
26 Leasing, Inc.), 478 F.3d 1291, 1298 (11th Cir. 2007) (issue of  
27 whether understanding of "single satisfaction" under Florida law  
28 informs interpretation of § 550(d)). Moreover,

1 [t]he presumption that state law should be incorporated  
2 into federal common law is particularly strong in areas  
3 in which private parties have entered legal  
4 relationships with the expectation that their rights  
5 and obligations would be governed by state-law  
6 standards. See [Kimbell Foods, 440 U.S.] at 728-729,  
7 739-740, 99 S.Ct., at 1458-1459, 1464-1465 (commercial  
8 law) . . . .”

9 Kamen, 500 U.S. at 98.

10 As a result, unless there are good reasons to depart from  
11 it, the UCC satisfies these requirements; it is, for the most  
12 part, a unifying code governing commercial transactions across  
13 and among the states that have adopted it. We thus start with  
14 the presumption that the hanging paragraph’s use of “purchase  
15 money security interest” should be construed consistently with  
16 the same term as in the UCC.

17 2. *The Role of the UCC*

18 A detailed examination of the UCC’s use of “purchase money  
19 security interest,” as modified in 2001, illustrates both the  
20 unifying and the fragmented features of that provision, at least  
21 with respect to its relevance to the hanging paragraph.

22 a. *Definitions*

23 Section 9-103 of the UCC defines purchase money security  
24 interests for the UCC. It states:

25 A security interest in goods is a purchase-money  
26 security interest:

27 (1) to the extent that the goods are  
28 purchase-money collateral with respect to that  
security interest; . . . .<sup>11</sup>

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<sup>11</sup> Other paragraphs of § 9-103(b) extend the concept of a purchase money security interest with respect to inventory and software, categorizations of collateral not applicable here.

1 UCC § 9-103(b). To understand this definition, however, a reader  
2 must also examine the embedded definitions it uses. These  
3 include the definitions of "purchase-money collateral" and  
4 "purchase-money obligation," terms that are defined in § 9-103(a)  
5 of the UCC:

6 (1) "purchase-money collateral" means goods or  
7 software that secures a purchase-money obligation  
8 incurred with respect to that collateral; and

9 (2) "purchase-money obligation" means an  
10 obligation of an obligor incurred as all or part of the  
11 price of the collateral or for value given to enable  
12 the debtor to acquire rights in or the use of the  
13 collateral if the value is in fact so used.

14 UCC § 9-103(a) (1) & (2).

15 The definition of "purchase-money obligation" is relevant  
16 here, as it defines two types of debt that may qualify: seller-  
17 based purchase money obligations, and financier-based purchase  
18 money obligations.

19 Seller-based PMSIs derive from the first part of UCC § 9-  
20 103(a) (2). That section states that a purchase-money obligation  
21 may consist of an "obligation of an obligor incurred as all or  
22 part of the price of the collateral . . . ." UCC § 9-103(a) (2).

23 As a result, a seller who transfers goods to a buyer while  
24 retaining a property interest in those goods retains a PMSI. The  
25 deferred purchase price is the purchase-money obligation, and the  
26 goods transferred are the purchase-money collateral. This usage  
27 comports with the traditional understanding of purchase money  
28 financing: a merchant retaining some interest in the property  
29 sold as a hedge against nonpayment of the purchase price.<sup>12</sup> The

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<sup>12</sup> That understanding also comports with similar historical understandings in the law of purchase money interest of real

(continued...)



1 inquiry under this section is thus whether the obligation  
2 incurred was part of the price of the collateral. In this case,  
3 the issue would be whether the negative equity was part of the  
4 price of the Taurus.

5 Financier-based PMSIs derive from the second part of UCC  
6 § 9-102(a)(2). That provision states that a purchase-money  
7 obligation may also consist of "an obligation of an obligor  
8 incurred . . . for value given to enable the debtor to acquire  
9 rights in or the use of the collateral if the value is in fact so  
10 used." UCC § 9-103(a)(2). As a result, if a bank extends credit  
11 to enable a buyer to purchase a car, the obligation to the bank  
12 is given for value in the form of the bank's enabling loan and is  
13 thus a "purchase-money obligation." The security interest in the  
14 car, the good acquired with the value given, is a PMSI. In terms  
15 of this case, the issue would be whether Penrod's obligation to  
16 Americredit, as it relates to the \$7,100 in negative equity added  
17 to the amount financed, was given to enable Penrod to actually  
18 acquire the Taurus.

19 b. *Effects and Consequences Under The UCC of*  
20 *Characterization as a PMSI*

21 PMSI characterization is not an end unto itself. The  
22 characterization is important because the UCC grants special  
23 rights to holders of claims secured by PMSIs, both in perfection  
24 and in priority. These rights arise in two basic situations.

25 The first has to do with common situations in which a seller  
26 retains a security interest in goods acquired as "consumer

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27  
28 <sup>12</sup> (...continued)  
property. See, e.g., Chierighino, 59 Cal.2d at 41, 378 P.2d at  
100, 27 Cal. Rptr. at 876 (Cal. 1963) (Traynor, J.).

1 goods." In this scenario, Article 9 does not require a creditor  
2 to file a UCC-1 financing statement in order to perfect a PMSI in  
3 consumer goods. UCC § 9-309(1).<sup>13</sup> This enables retailers to  
4 take a security interest in goods bought by consumers without  
5 clogging the filing system.

6 A second benefit conferred on holders of PMSIs has to do  
7 with priority. Holders of PMSIs in goods or software can obtain  
8 priority over a prior-filed lien; this is an exception to the  
9 general "first in time is first in priority" structure used by  
10 the UCC. UCC § 9-324. This exception has generally been  
11 justified on equitable notions: it protects vendors of goods from  
12 after-acquired property clauses generally used by banks and other  
13 financiers. See GILMORE, supra, at 779 ("What might be called the  
14 'Don't be a Pig' school of advice to Article 9 lenders has a  
15 fashionable currency and may be expected to have some influence  
16 on lending patterns."); James J. White, Reforming Article 9 in  
17 Light of Old Ignorance and the New Filing Rules, 79 MINN. L. REV.  
18 529, 562 (1995) ("[T]he most persuasive claim for purchase money  
19 priority is the fairness argument - that reasonable  
20 businesspeople expect to have priority when they sell goods from  
21 their own stock").

22 These exceptions often lead to litigation and to efforts to  
23 characterize transactions in which elements of both normal and  
24 purchase-money financing exist. As was acknowledged before  
25 Article 9's revision and afterward, a security interest - the  
26 contingent "interest in personal property or fixtures which

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27  
28 <sup>13</sup> Security interests in consumers' cars, of course, are  
not perfected by the filing of a financing statement.  
Certificate of title statutes control. UCC § 9-311(a)-(b).

1 secures payment or performance of an obligation"<sup>14</sup> - can be both  
2 purchase-money and nonpurchase-money at the same time, either  
3 through refinancing, cross-collateralization, or cross-default  
4 clauses. The issue then arises as to whether the PMSI survives,  
5 and if so, how to treat it. Several views arose.

6 The harshest rule for creditors was the Transformation Rule.  
7 Under this rule, mixing the PMSI with non-PMSI debt or collateral  
8 destroyed the PMSI, and nullified all the benefits given to the  
9 holder of a PMSI. See, e.g., Snap-On Tools, Inc. v. Freeman (In  
10 re Freeman), 956 F.2d 252 (11th Cir. 1992); CLARK & CLARK, supra,  
11 at ¶ 3.09[2][c][i].

12 An alternate view arose that focused on former Article 9's  
13 use of "to the extent" in the section describing a PMSI. See UCC  
14 § 9-107 (1995 Official Text). This language was thought to  
15 authorize a security interest's characterization as part PMSI and  
16 part non-PMSI. This Dual Status Rule allowed creditors to retain  
17 the benefits of purchase money status for some of the debt or  
18 collateral, but it raised issues related to that allocation.  
19 See, e.g., Billings v. Avco Colo. Indus. Bank (In re Billings),  
20 838 F.2d 405 (10th Cir. 1988); In re Pan Am Corp., 124 B.R. 960,  
21 970-72 (Bankr. S.D.N.Y.), aff'd mem., 125 B.R. 372 (S.D.N.Y.),  
22 aff'd, 929 F.2d 109 (2d Cir.), cert. denied, 500 U.S. 946 (1991)  
23 (§ 1110).

### 24 3. *Issues for This Appeal*

25 If Article 9's understandings of purchase money security  
26 interests guide interpretation of the hanging paragraph, several  
27

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28 <sup>14</sup> Revised UCC § 1-201(b) (35) (Official 2007 Text),  
incorporated into Revised Article 9 by § 9-102(c).

1 questions arise. First, is negative equity part of the "price"  
2 of the purchase of the car under § 9-103(a)(2)? In particular,  
3 was the \$7,100 in debt assumed by Americredit part of Penrod's  
4 purchase price? Second, and independently, is negative equity  
5 part of the "value given to enable the debtor to acquire rights  
6 in" the car? Here, that question would be whether Americredit's  
7 assumption of the unsecured deficiency was "value" that  
8 "enable[d]" Penrod to acquire the Taurus.

9 If the answer to either of these questions is yes, then the  
10 entire amount of the debt owed to Americredit is secured by a  
11 purchase money security interest and must be paid in full through  
12 the plan. If, however, any portion of Americredit's claim  
13 represented by negative equity cannot be characterized as  
14 purchase-money debt, we then reach the issue of whether the  
15 combination of that debt with purchase-money debt invokes the  
16 Transformation Rule or the Dual Status Rule. And only if the  
17 Dual Status Rule is applicable do we reach issues of allocation  
18 between what is purchase-money debt and what is not.

1           **C.    How Should Federal Courts Interpret Negative Equity and**  
2           **PMSIs under § 1325(a)'s Hanging Paragraph?**

3           A great deal of attention has been paid to the proper role  
4 of negative equity.<sup>15</sup> Cases exist going both ways. See In re  
5 Sanders, 377 B.R. 836, 845 (Bankr. W.D. Tex. 2007). But on  
6 balance, the better-reasoned cases find that the portion of a  
7 secured creditor's claim that is allocable to negative equity is  
8 not supported by a PMSI.

9           1.    *Is Negative Equity Part of the Purchase Price?*

10          Courts have held that the financing extended to cover  
11 negative equity is part of the "price of the collateral," relying  
12 primarily on two arguments: the first construes Official Comment  
13 3 to § 9-103 of the UCC to include negative equity; and the  
14 second invokes the doctrine of in pari materia to conflate the  
15 definition of cash sale price contained in state automobile sales  
16 and finance laws with the term "price of the collateral" in UCC  
17 § 9-103. Neither is ultimately persuasive.

18 \_\_\_\_\_  
19          <sup>15</sup> In rationalizing a long explanation of issues similar to  
20 those analyzed in this opinion, Judge James Haines had this to  
21 say:

22               I say the explanation will be lengthy. Although it will  
23 be long enough to test many readers' patience, I do not  
24 intend to recite the rationale's recipe from scratch.  
25 Many courts have explained the issues and options  
26 comprehensively. This opinion will reference their  
27 work and refer the reader to it, rather than repeat it  
28 here.

26 In re Look, 383 B.R. 210, 212 n.2 (Bankr. D. Me. 2008). To the  
27 extent possible, this opinion adopts Judge Haines's  
28 rationalization and attempts also to reduce the repetition of  
arguments already made and resolved by other judges. The end  
result, however, is still "long enough to test many readers'  
patience."

1 a. "Price of the Collateral" and Comment 3

2 Section 9-103 refers to the "price" of the collateral, but  
3 the UCC does not define "price." Official Comment 3 provides  
4 some guidance as to its meaning:

5 [T]he "price" of collateral or the "value given to  
6 enable" includes obligations for expenses incurred in  
7 connection with acquiring rights in the collateral,  
8 sales taxes, duties, finance charges, interest, freight  
9 charges, costs of storage in transit, demurrage,  
10 administrative charges, expenses of collection and  
11 enforcement, attorney's fees, and other similar  
12 obligations.

13 In analyzing this passage, one court on appeal has stated that  
14 "[i]t is not apparent why a refinancing of rolled-in negative  
15 equity on a trade-in as part of a motor vehicle sale could not  
16 constitute an 'expense incurred in connection with acquiring  
17 rights in' the new vehicle." General Motors Acceptance Corp. v.  
18 Peaslee, 373 B.R. 252, 259 (W.D.N.Y. 2007) ("Peaslee II"). The  
19 court continued: "[i]f the buyer and seller agree to include the  
20 payoff of the outstanding balance on the trade-in as an integral  
21 part of their transaction for the sale of the new vehicle, it is  
22 difficult to see how that could not be viewed as such an  
23 expense." Id. (emphasis in original). See also In re Austin, 381  
24 B.R. 892 (Bankr. D. Utah 2008); In re Schwalm, 380 B.R. 630  
25 (Bankr. M.D. Fla. 2008); In re Weiser, 381 B.R. 263 (Bankr. W.D.  
26 Mo. 2007).

27 Official Comment 3 further requires that for a PMSI to  
28 arise, there must be a "close nexus between the acquisition of  
the collateral and the secured obligation." Com. 3 to UCC § 9-  
103. Some courts have found this close nexus in the financing of  
negative equity because the parties have agreed to a "package

1 transaction." See, e.g., Graupner v. Nuvel Credit Corp. (In re  
2 Graupner), 4:07-CV-37CDL, 2007 WL 1858291 at \*2 (M.D. Ga. June  
3 26, 2007) ("The negative equity is inextricably intertwined with  
4 the sales transaction and the financing of the purchase."); In re  
5 Vinson, \_\_\_ B.R. \_\_\_, 65 UCC Rep. Serv. 2d 67, 2008 WL 319678  
6 (Bankr. D.S.C. 2008).

7 Using the same sources, many other courts hold that negative  
8 equity is not a component of the "price of the collateral." One  
9 line of reasoning refutes the idea that negative equity is one of  
10 the "expenses incurred in connection with acquiring rights in the  
11 collateral" contemplated by Official Comment 3. These cases  
12 essentially hold that such a major part of the purchase price can  
13 hardly be a form of 'expense' incurred in order to acquire the  
14 car. See, e.g., In re Wear, 64 UCC Rep. Serv. 2d 969, 2008 WL  
15 217172 (Bankr. W.D. Wash 2008); In re Look, 383 B.R. 210 (Bankr.  
16 D. Me. 2008); In re Riach, 65 UCC Rep. Serv. 2d 25, 2008 WL  
17 474384 (Bankr. D. Or. 2008); In re Pajot, 371 B.R. 139, 149-50  
18 (Bankr. E.D. Va. 2007); In re Price, 363 B.R. 734, 741 (Bankr.  
19 E.D.N.C. 2007).

20 Sanders contains a good discussion of this point:

21 The [expense] items listed [in Official Comment 3] are  
22 closely connected with the purchase of the vehicle  
23 itself - compensating the seller for the cost of  
24 delivering the vehicle, repaying the seller for sales  
25 taxes realized from the sale of the vehicle, paying for  
26 such administrative charges as title costs and license  
27 fees associated with transferring ownership of the  
28 vehicle from seller to buyer, and the like. In  
addition, the list includes costs normally associated  
with the enforcement of the security interest once  
granted....

1 In re Sanders, 377 B.R. at 855. See also In re Conyers, 379 B.R.  
2 at 581; In re Pajot, 371 B.R. at 152.<sup>16</sup>

3 Given that financing negative equity is increasingly common,  
4 it was likely not an oversight that the reporters for Article 9  
5 did not include negative equity in Comment 3's list of "expenses  
6 incurred in connection with acquiring rights in the collateral."  
7 In re Blakeslee, 377 B.R. 724, 728-29 (Bankr. M.D. Fla. 2007).  
8 Further, negative equity is not of the same "type" or "magnitude"  
9 as the expenses listed in Official Comment 3. Id. at 729.

10 Other courts reach the same conclusion by reading Comment 3  
11 to mean that simply including negative equity in a single car  
12 contract does not by itself create a sufficient nexus between the  
13 acquisition of the collateral and the secured obligation to  
14 transform negative equity into part of the price of the vehicle.  
15 Rather, in that circumstance, there are simply "two separate  
16 financial transactions memorialized on a single retail  
17 installment contract document...." In re Price, 363 B.R. at 741.  
18 See also Citifinancial Auto v. Hernandez-Simpson (In re  
19 Hernandez-Simpson), 369 B.R. 36 (D. Kan. 2007); In re Mitchell,  
20 379 B.R. 131 (Bankr. M.D. Tenn. 2007).

21 This line of reasoning is exemplified by Sanders:

22  
23  
24 <sup>16</sup> But in In re Austin the court found, on the facts of the  
25 case, that financing the negative equity was necessary to acquire  
26 rights in the vehicle. 381 B.R. 892 (Bankr. D. Utah 2008).  
27 There, the debtors could not afford payments on both the new  
28 vehicle and the trade-in and would have presented a credit risk  
if they otherwise failed to pay the balance on the trade-in  
before buying the new vehicle. Id. at 894. The bank testified  
that the debtors would not have qualified for, and the bank  
therefore would not have financed, a loan without including the  
negative equity. Id.



1 Context thus bolsters the conclusion that "price of the  
2 collateral" need not be given some exotic meaning or  
3 treated as some peculiar argot to sweep up more than  
4 the common understanding of the phrase is intended to  
5 convey. One may borrow money to buy something (e.g., a  
6 new vehicle), and also borrow additional money for some  
7 other purpose (e.g., to pay off the balance of a loan  
8 for the trade-in vehicle). The part used to buy  
9 something is purchase money obligation. The part used  
10 for some other purpose is not. We can tell what part  
11 was used to buy something by simply looking at the  
12 price of the thing purchased.

13 In re Sanders, 377 B.R. at 853.

14 The result in Sanders and like cases better reflects the  
15 goals of chapter 13 and the language of the hanging paragraph.  
16 "Negative equity is not similar in nature or scope to the other  
17 'expenses incurred in connection with acquiring rights in the  
18 collateral' contemplated by Official Comment 3." In re Johnson,  
19 380 B.R. 236, 243 (Bankr. D. Or. 2007). More importantly, as  
20 Lavigne noted, the critical issue is that the liability for  
21 negative equity is not an expense "incurred in connection with  
22 acquiring" the car; it is the auto seller's assumption of one of  
23 debtor's antecedent debts.

24 That liability necessarily preceded the acquisition.  
25 The preexisting indebtedness was simply rolled into the  
26 new car loan. As the court observed in Pajot, "the  
27 substance of the transaction, although instantaneous,  
28 is that the second creditor is paying off the debtor's  
unsecured deficiency debt on the first vehicle."  
Pajot, 371 B.R. at 154.

In re Lavigne, 2007 WL 3469454 at \*8.

b. "Price of the Collateral" and In Pari Materia

Many states, as part of legislation designed to inform  
consumers of the true cost of credit, require financiers to  
disclose negative equity as part of the price of a new car loan.  
See Graupner, at \*2 n.2; In re Cohrs, 373 B.R. 107 (Bankr. E.D.

1 Cal. 2007); In re Petrocci, 370 B.R. 489, 501 (Bankr. N.D.N.Y.  
2 2007); Peaslee II, 373 B.R. at 260. Since a state statute thus  
3 includes negative equity in a definition of price, these courts  
4 invoke the interpretive doctrine of in pari materia and interpret  
5 "price" in Article 9 the same as in the state disclosure law.  
6 See, e.g., GMAC v. Horne, \_\_\_ B.R. \_\_\_, 2008 WL 2662024 (E.D. Va.  
7 2008).

8 Courts have rejected this reasoning for many good and  
9 sufficient reasons. First, some courts hold that because the  
10 term "price of the collateral" in § 9-103 is not ambiguous, the  
11 doctrine of in pari materia is not available. See In re  
12 Blakeslee, 377 B.R. at 728; In re Acaya, 369 B.R. 564, 570  
13 (Bankr. N.D. Cal. 2007). At least one other court declined to  
14 use the in pari materia doctrine to graft the definition of "cash  
15 sale price" from state automobile sales and finance laws onto the  
16 term "price of the collateral" as used in the UCC because the two  
17 statutes do not relate to the same subject matter or do not have  
18 the same purpose. See, e.g., In re Lavigne, Nos. 07-30192,  
19 07-31402, 07-31247, 06-32914, 2007 WL 3469454, at \*7 (Bankr. E.D.  
20 Va. Nov. 14, 2007).

21 Despite these arguments, Americredit requests that we use  
22 California's doctrine of in pari materia to incorporate into the  
23 UCC term "price of the collateral" the definition of "cash sale  
24 price" from California's automobile sales and finance law, found  
25 at CAL. CIVIL CODE § 2981(e).<sup>17</sup> We do not adopt this argument. As

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26  
27 <sup>17</sup> That section provides:

28 (e) "Cash price" means the amount for which the  
seller would sell and transfer to the buyer unqualified  
(continued...)

1 an initial matter, it would require us to use a state-law based  
2 interpretive rule to construe how a federal statute would  
3 incorporate a state statute. That is too convoluted to withstand  
4 any rigorous analysis under Kamen or any other authority.

5 In addition, the statute that Americredit points to does not  
6 apply to car loans extended by state or federally chartered  
7 banks, CAL. CIVIL CODE § 2982.5(d)(6), thereby raising the  
8 possibility of a difference of application due solely to the  
9 status of the creditor, a result violently at odds with the  
10 general goal of uniformly construing federal statutes.

11 Even if employed California's doctrine of in pari materia,  
12 it would fail for two reasons. First, the provisions of the  
13 California Civil Code are part of a regulatory network based on  
14 disclosure. Including negative equity in these provisions  
15 ensures that consumers know what they are getting into - and that  
16 is the sole function of these provisions, which are designed to  
17 inform the vast majority of consumers who buy cars and finance  
18 negative equity, but never file bankruptcy.

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21 <sup>17</sup>(...continued)  
22 title to the motor vehicle described in the conditional  
23 sale contract, if the property were sold for cash at  
24 the seller's place of business on the date the contract  
25 is executed, and shall include taxes to the extent  
26 imposed on the cash sale and the cash price of  
27 accessories or services related to the sale, including,  
28 but not limited to, delivery, installation,  
alterations, modifications, improvements, document  
preparation fees, a service contract, a vehicle  
contract cancellation option agreement, and payment of  
a prior credit or lease balance remaining on property  
being traded in.

Cal. Civil Code § 2981(e) (emphasis added).

1           When looking at the hanging paragraph, however, the function  
2 is starkly different: instead of disclosure designed to protect  
3 consumers, giving negative equity PMSI status effectively  
4 enriches car lenders at the expense of the debtor's unsecured  
5 creditors. With such different effects and goals, the two  
6 provisions - one based on disclosure and the other on preference  
7 - are not in pari materia. See In re Acaya, 369 B.R. at 568-71  
8 (analyzing history of § 2981(e)).<sup>18</sup>

9           Second, the California legislature itself has indicated that  
10 interpretation of its version of Article 9 should not be affected  
11 by the provisions of Civil Code § 2981. Notably, § 9201(b) of  
12 the California UCC provides that a transaction subject to  
13 California's version of Article 9 is also subject to the  
14 provisions of the California's Automobile Sales Finance Act (of  
15 which § 2981 is a part), stating:

16                   (b) A transaction subject to this division [9 of  
17 the California Uniform Commercial Code] is subject to  
18 ... the Automobile Sales Finance Act, Chapter 2b  
(beginning with Section 2981) of Title 14 of Part 4 of  
Division 3 of the Civil Code....

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20           <sup>18</sup> That negative equity is not part of the price is also  
21 negated somewhat by the structure of federal regulation of  
22 consumer credit. Regulation Z, which regulates the disclosure of  
23 consumer credit terms, does not explicitly include negative  
equity as part of the "cash price." It defines "cash price" as:

24                   (9) Cash price means the price at which a  
25 creditor, in the ordinary course of business, offers to  
26 sell for cash the property or service that is the  
27 subject of the transaction. At the creditor's option,  
the term may include the price of accessories, services  
28 related to the sale, service contracts and taxes and  
fees for license, title, and registration. The term  
does not include any finance charge.

12 C.F.R. § 226.2(a)(9)(2007).

1 CAL. COM. CODE § 9201(b). We read this to mean that both acts  
2 operate independently, thereby essentially negating any  
3 legislative intent that similar provisions in each be construed  
4 identically. In re Acaya, 369 B.R. at 568 (citing Bank of Am. v.  
5 Lallana, 19 Cal. 4th 203, 77 Cal. Rptr. 2d 910, 960 P.2d 1133  
6 (1998)). See also Thompson v. 10,000 RV Sales, Inc., 130 Cal.  
7 App. 4th 950, 31 Cal. Rptr. 3d 18 (Cal. Ct. App. 2005) (reviewing  
8 function and purpose of disclosure of negative equity under  
9 California law).

10 As a result, negative equity is not part of the price as  
11 that term is used in California's version of § 9-103(a)(1).

12 2. *Does Financing Negative Equity Enable the*  
13 *Acquisition of the Purchased Collateral?*

14 A purchase-money obligation can also arise based on "value  
15 given to enable the debtor to acquire rights in or the use of the  
16 collateral if the value is in fact so used." UCC § 9-103(a)(2).  
17 Not surprisingly, there is considerable overlap in the analyses  
18 that courts have used in interpreting the phrase "value given to  
19 enable the debtor to acquire rights in or the use of the  
20 collateral if the value is in fact so used" and in determining  
21 the meaning of "price of the collateral." That overlap  
22 principally occurs when construing Official Comment 3 to § 9-103,  
23 and its indication that "[t]he concept of 'purchase-money  
24 security interest' requires a close nexus between the acquisition  
25 of collateral and the secured obligation."

26 There is greater division among courts on the question of  
27 whether "value given" in the form of financing negative equity  
28 creates a close nexus with the acquisition of collateral. Some

1 courts have found the requisite close nexus based on the package  
2 or unitary nature of the transaction itself. For instance, in  
3 finding that “[t]he phrase, ‘value given to enable the debtor to  
4 acquire rights in’ purchase money collateral is broad enough to  
5 include the ‘negative equity’ financed by a lender,” one court  
6 found the required “close nexus” between the acquisition of the  
7 property and the secured obligation existed where the financed  
8 negative equity was “part of a single transaction and all  
9 components of the obligation incurred [were] for the purpose of  
10 acquiring the property securing the new obligation.” In re  
11 Cohrs, 373 B.R. at 109-10. See also In re Brei, No.  
12 4:07-BK-01354-JMM, 2007 WL 4104884 at \*1 (Bankr. D. Ariz. Nov.  
13 14, 2007); In re Petrocci, 370 B.R. at 499.

14 Other courts have determined that negative equity financing  
15 does not provide the direct assistance for purchasing a vehicle  
16 that the standard “for value given to enable the debtor to  
17 acquire rights in . . . the collateral” requires. For example,  
18 Sanders recognized a distinction between facilitating a  
19 transaction and enabling a debtor to acquire rights in a new  
20 vehicle. “The fair implication of this [condition that the value  
21 given be ‘in fact so used’] is that the value must be used to  
22 acquire rights in the collateral, as opposed to, for example,  
23 enabling the transaction that ultimately results in the borrowers  
24 acquiring rights in the collateral.” In re Sanders, 377 B.R. at  
25 855 (emphasis in original); In re Blakeslee, 377 B.R. at 729.  
26 See also In re Pajot, 371 B.R. at 154. See also GMAC v. Horne,  
27 2008 WL 2662024 (sums advanced for gap insurance, disability  
28 insurance, extended warranties and service contracts were not

1 secured by PMSIs, and thus amounts related thereto could be  
2 bifurcated).

3 Still other courts look to the language "value given to  
4 enable" in an effort to determine whether financing negative  
5 equity qualifies as a purchase money obligation. Starting with  
6 Black's Law Dictionary's definition of "enable," the Conyers  
7 court concluded that financing negative equity was not required  
8 for the debtor to purchase a new vehicle. Rather, the loan of  
9 additional money was "a convenience and an accommodation to the  
10 Debtor." In re Conyers, 379 B.R. at 582.<sup>19</sup>

11 Acaya found the words "value given to enable the debtor to  
12 acquire rights in or the use of the collateral if the value is in  
13 fact so used" were ambiguous in the context of the hanging  
14 paragraph. In re Acaya, 369 B.R. at 569. Applying Matthews v.  
15 Transamerica Fin. Servs. (In re Matthews), 724 F.2d 798 (9th Cir.  
16 1984), which held that a refinance destroyed the purchase money  
17 character of an obligation, as part of its rationale, the Acaya  
18 court concluded that "the amount used to pay the negative equity  
19 does not constitute . . . value given to acquire rights in the  
20 collateral. . . ." In re Acaya, 369 B.R. at 570.

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23 <sup>19</sup> An argument exists within Article 9 that value given is  
24 an exceptionally easy concept to meet. Under the UCC generally,  
25 "value" is defined not only as something sufficient to support a  
26 simple contract, but also as the granting of a security interest,  
27 or the existence or assumption of antecedent debt. UCC § 1-204  
28 (2003). Thus, a lender can easily say that "value" in the form  
of a loan assumption on the trade-in was given to the debtor. As  
developed in text below, the existence of value in a transaction  
is not the same as providing value that enables the debtor to  
acquire goods.

1 In Matthews, the Ninth Circuit addressed the character of an  
2 enabling loan in deciding a motion to avoid a non-PMSI in  
3 debtor's property under § 522 of the Bankruptcy Code. Matthews,  
4 724 F.2d at 799-801. While Matthews arose in the context of lien  
5 avoidance and predated the enactment of revised Article 9, it is  
6 nevertheless instructive for this case. Prerevision UCC § 9-107  
7 defined a PMSI as a security interest taken by a person who  
8 "gives value to enable the debtor to acquire rights in or use of  
9 collateral if such value is in fact so used."<sup>20</sup> Matthews  
10 articulates that a refinance constitutes value to enable debtors  
11 to pay off a loan, not to acquire rights in collateral. Speaking  
12 to the apparent harshness of the loss of a PMSI through a  
13 refinance, the Matthews court stated:

14 The argument that form should not be elevated over  
15 substance has merit in some settings, but not here. We  
16 are dealing with a statutory scheme that governs the  
17 priorities among creditors. Purchase money security is  
18 an exceptional category in the statutory scheme that  
19 affords priority to its holder over other creditors,  
20 but only if the security is given for the precise  
21 purpose as defined in the statute. And we should not  
22 lose sight of the fact that the lender chooses the  
23 form.

24 Id. at 801.

25 Given the ease with which a transaction under the UCC can be  
26 infused with "value" (see note 19 above), it is not enough under  
27 § 1325(a) that value be given to acquire rights in the vehicle.  
28 As noted by Sanders, under § 9-103 the value given must be "in  
fact so used." 377 B.R. at 855. In most cases, including the

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<sup>20</sup> This is essentially the same phrase used in the current  
UCC § 9-103(a)(2), except that in the current version, the  
article "the" is inserted before "collateral."



1 current appeal, the financed negative equity is nothing more than  
2 a refinancing of the preexisting debt owed on the trade-in.  
3 There is no necessary connection between this refinancing and the  
4 car's acquisition. If Penrod had shown up with no trade-in, the  
5 amount ultimately financed for the same car would have been  
6 \$7,100 less (assuming that Penrod paid the extra \$6,000 as a down  
7 payment).

8 Similarly, to take a fanciful example, if a car lender  
9 offered to pay off a car buyer's second mortgage as a promotional  
10 campaign for new car sales, and then rolled the amount of the  
11 mortgage into the amount financed, the payment of the mortgage  
12 would be value under § 1-204, but it could not fairly be said to  
13 be part of the purchase-money debt. The distinction that Sanders  
14 makes between debt incurred to acquire the car and debt incurred  
15 to finance the car is relevant. Accordingly, there is not the  
16 requisite close nexus between "value given" and Penrod's  
17 acquisition of rights in the Taurus.

18 Since neither paragraph of § 9-103(a) applies here, it  
19 cannot be said that the negative equity assumed by Americredit is  
20 purchase-money debt. As such, that part of Americredit's claim  
21 that consists of negative equity is not secured by a purchase  
22 money security interest.

23 **D. If Americredit's Security Interest Is Not Entirely a**  
24 **PMSI, What Should Be the Effect Under 1325(a)?**

25 If, as we have determined above, a creditor's PMSI does not  
26 secure negative equity, then the focus turns to the secured  
27 creditor's proper treatment under the hanging paragraph. At  
28 least two different results have been suggested: that the

1 creditor should lose the entire benefit of the hanging paragraph,  
2 or that the creditor should receive the benefits of the hanging  
3 paragraph, but only to the extent that the security interest is a  
4 PMSI.<sup>21</sup>

5 1. *The Decreased Need to Defer to State Law*

6 Here, as before, Kamen's indication that state law should  
7 normally be used to fill any gaps guides us. Kamen, 500 U.S. at  
8 98. But Kamen is not inflexible, and its result is not  
9 inexorable. "[F]ederal courts may properly devise a uniform  
10 federal common law when 'the scheme in question evidences a  
11 distinct need for nationwide legal standards, or when express  
12 provisions in analogous statutory schemes embody congressional  
13 policy choices readily applicable to the matter at hand, . . .  
14 [or when] application of [the particular] state law [in question]  
15 would frustrate specific objectives of the federal programs.'" Ford v. Uniroyal Pension Plan, 154 F.3d 613, 616 (6th Cir. 1998)  
16 (quoting Kamen, 500 U.S. at 98) (citations and quotations  
17 omitted).  
18

19 There are at least three reasons under this standard for  
20 federal courts to depart from the traditional deference to the  
21 UCC when construing the effect of a "hybrid" PMSI. First, the  
22 UCC itself neither prescribes a uniform result, nor is it uniform  
23

---

24 <sup>21</sup> Arguably, a third view exists: ignore the fact that  
25 negative equity does not support PMSIs. Cf. CLARK & CLARK, supra  
26 ¶ 6.10[4][d]. We reject this view for at least two reasons.  
27 First, it is in part based on the notion that negative equity can  
28 be secured by a PMSI. As noted above, we reject that premise.  
Second, once we determine that negative equity is not secured by  
a PMSI in this case, there must be some consequence under  
§ 1325(a). Otherwise, we essentially ignore the words "purchase  
money security interest" in the hanging paragraph.

1 from state to state on this point. This engenders a need to  
2 develop uniform federal standards for the unitary interpretation  
3 of the hanging paragraph. Second, the main comment to the  
4 relevant UCC section indicates that the terms in that statute  
5 were not designed to inform or influence the Bankruptcy Code.  
6 This undercuts any argument designed to transfer understandings  
7 from the UCC to the hanging paragraph based on commercial  
8 understandings that the UCC understanding should control any time  
9 any statute used the term "purchase money security interest."  
10 Third, and related to the second point, an examination of the  
11 UCC's development and use of "purchase-money security interest"  
12 reveals a substantially different purpose, both in practice and  
13 in drafting, that the same term serves in the hanging paragraph.

14 a. The Nonuniform Treatment of Consumer PMSIs  
15 Under the UCC

16 Dividing a creditor's secured claim into two - one secured  
17 by a PMSI, and the other not - would normally not raise issues  
18 under Kamen if the consequences of such a division were clear and  
19 easy to apply. But Article 9 is far from clear on this point.  
20 The starting point of this analysis is the many perfection and  
21 priority issues that PMSIs raise. Given the special status of  
22 PMSIs in UCC perfection and priority disputes, many prerevision  
23 judicial decisions debated to what extent a vendor or other  
24 secured party could extend or modify the purchase money concept.  
25 See CLARK & CLARK, supra, ¶ 3.09. The extent to which a PMSI could  
26 be cross-collateralized or cross-defaulted with non-PMSI  
27 collateral and debt was hotly debated. Id.

28

1 Revised Article 9 sought to settle these issues as to  
2 nonconsumers. In particular, under Revised Article 9, the holder  
3 of a nonconsumer PMSI may: cross-secure nonpurchase-money debt as  
4 well as purchase-money debt, § 9-103(f)(1); cross-collateralize  
5 purchase money collateral with nonpurchase money collateral,  
6 § 9-103(f)(2); renew, refinance, consolidate or restructure  
7 purchase-money security interests, § 9-103(f)(3). The contract  
8 that creates the PMSI may allocate any payments received in any  
9 way, and that allocation will bind the parties. § 9-103(e). In  
10 case of any dispute, it is the debtor's burden to show variance  
11 with these rules. § 9-103(g).

12 In addition, to the extent that the scope of the PMSI  
13 matters in nonconsumer matters, Comment 7a to § 9-103 indicates  
14 that the Dual Status Rule is preferred. It states:

15 For transactions other than consumer-goods  
16 transactions, this Article approves what some cases  
17 have called the "dual-status" rule, under which a  
18 security interest may be a purchase-money security  
19 interest to some extent and a non-purchase-money  
20 security interest to some extent.

21 Official Comment 7a to UCC § 9-103 (emphasis added).

22 These PMSI rules, if nothing else, are clear. But would  
23 they apply in this case if the UCC governed? That issue would be  
24 decided by § 9-103(h), the key section for present purposes:

25 The limitation of the rules in subsections (e), (f),  
26 and (g) to transactions other than consumer-goods  
27 transactions is intended to leave to the court the  
28 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.

1 UCC § 9-103(h) (emphasis added). In other words, the new PMSI  
2 rules in revised Article 9 do not apply to consumer-goods  
3 transactions.

4 To understand this exclusion for consumers, we must examine  
5 both § 9-103's text and its history. First, as a matter of  
6 statutory interpretation, the exclusion of some consumers from  
7 the rules related to purchase money security interests applies  
8 only to "consumer-goods transactions." That term is defined in  
9 § 9-102(a) as follows:

10 (24) "Consumer-goods transaction" means a  
11 consumer transaction in which:

12 (A) an individual incurs an obligation  
13 primarily for personal, family, or household  
14 purposes; and

15 (B) a security interest in consumer goods  
16 secures the obligation.

17 This definition requires understanding of what a "consumer  
18 transaction" is, and that term is also defined in § 9-102(a):

19 (26) "Consumer transaction" means a transaction  
20 in which

21 (i) an individual incurs an obligation  
22 primarily for personal, family, or household  
23 purposes,

24 (ii) a security interest secures the  
25 obligation, and

26 (iii) the collateral is held or acquired  
27 primarily for personal, family, or household  
28 purposes. The term includes consumer-goods  
29 transactions.

30 Why does subsection (h) exclude such consumer transactions, and  
31 why does it contain the strange provision forbidding courts to  
32 infer that the business rules apply to consumers?<sup>22</sup> The answer is  
33 unclear, but for present purposes, the upshot of this exclusion

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34 <sup>22</sup> A partisan's view is recounted in Charles W. Mooney,  
35 Jr., The Consumer Compromise in Revised U.C.C. Article 9: The  
36 Shame of It All, 68 OHIO ST. L.J. 215 (2007).

1 is that the UCC has no clear answer on what rule to apply to  
2 consumers. There is a textual abdication and agnosticism in  
3 revised Article 9 regarding the proper treatment of consumer  
4 issues. UCC § 9-103(h); see also UCC § 9-626(b) (adopting same  
5 approach to proper rule regarding availability of deficiency  
6 against consumers when secured party does not conduct foreclosure  
7 in compliance with Article 9). This "hands off" approach permits  
8 different interpretations among states and also may lead to  
9 different results within a state.

10 Even worse, § 9-103(h) has not been uniformly adopted by the  
11 states. At least nine states, including one in the Ninth  
12 Circuit, did not adopt it. U.C.C. § 9-103, 3 U.L.A. 91-92 & Supp.  
13 26 (2002 & Supp. 2008). The states include Florida, FLA. STAT.  
14 ANN. § 679.1031 (2007); Idaho, IDAHO CODE ANN. § 28-9-103 (2007);  
15 Indiana, IND. CODE ANN. § 26-1-9.1-103 (2007); Kansas, KAN. STAT.  
16 ANN. 84-9-103 (2007); Louisiana, LA. REV. STAT. ANN. § 10:9-103  
17 (2007); Maryland, MD. CODE ANN., COM. LAW § 9-103 (2007); Nebraska,  
18 NEB. REV. STAT. ANN., U.C.C. § 9-103 (2007); North Dakota, N.D.  
19 CENT. CODE § 41-09-03 (2007); and South Dakota, S.D. CODIFIED LAWS §  
20 57A-9-103 (2007).

21 At least in this critical respect, the Uniform Commercial  
22 Code is not uniform. As a result, the likelihood of uniform  
23 interpretation of state law is not high.

24 This nonuniformity raises significant concerns with respect  
25 to any proposal to borrow the UCC "interpretation" in an effort  
26 to achieve a uniform application of the hanging paragraph. As  
27 the Supreme Court has stated, "[u]ndoubtedly, federal programs  
28 that 'by their nature are and must be uniform in character

1 throughout the Nation' necessitate formulation of controlling  
2 federal rules." United States v. Kimbell Foods, Inc., 440 U.S.  
3 715, 728 (1979) (quoting United States v. Yazell, 382 U.S. 341,  
4 354 (1966)).

5 b. The UCC's Disavowal of the Intent to Inform  
6 Interpretation of the Bankruptcy Code Terms

7 In addition to the problem of nonuniformity, there is no  
8 recourse to the notion that the term "purchase money security  
9 interest" has a nonfederal meaning that permeates commerce. This  
10 is shown by the UCC itself, which reflects a much more limited  
11 scope that intentionally does not extend to federal law. Comment  
12 8 to § 9-103 states:

13 This section addresses only whether a security interest  
14 is a "purchase-money security interest" under this  
15 Article, primarily for purposes of perfection and  
16 priority. See, e.g., §§ 9-317, 9-324. In particular,  
17 its adoption of the Dual-Status Rule, allocation of  
18 payments rules, and burden of proof standards for  
19 non-consumer-goods transactions is not intended to  
20 affect or influence characterizations under other  
21 statutes. Whether a security interest is a  
22 "purchase-money security interest" under other law is  
23 determined by that law. For example, decisions under  
24 Bankruptcy Code Section 522(f) have applied both the  
25 dual-status and the transformation rules. The  
26 Bankruptcy Code does not expressly adopt the state law  
27 definition of "purchase-money security interest."  
28 Where federal law does not defer to this Article, this  
Article does not, and could not, determine a question  
of federal law.

23 Comment 8 to UCC § 9-103 (emphasis added).

24 As the emphasized language makes clear, the drafters of the  
25 2001 revisions to Article 9 knew that federal courts had already  
26 split in interpreting "purchase money security interest" under  
27 § 522(f) and other provisions. They thus demurred and stated the  
28 obvious: state law cannot control federal law. The addition of

1 this comment by the reporters undercuts one of Kamen's key  
2 underpinnings, that commercial law requires uniformity of  
3 construction. Here, at least, the UCC itself rejects that  
4 conclusion and leaves to federal bankruptcy law to fashion  
5 interpretations consistent with the expectations of commerce and  
6 the goals of the federal statute.

7 c. The Differences in Purpose

8 Comment 8 correctly states obvious federal supremacy  
9 concerns. As it indicates, the choices made in drafting the  
10 revised Article 9 were meant to deal with the functions of  
11 purchase money security interests in a state's commercial law  
12 system; the drafters did not aspire to create a definition that  
13 served federal bankruptcy goals as well.

14 All of which leads to an examination of the function of the  
15 hanging paragraph as it appears in the federal bankruptcy system.  
16 Strong reasons to borrow from state law would exist if the  
17 purposes of the hanging paragraph were congruent with the  
18 purposes of having PMSI's in Article 9; conversely, Kamen's  
19 concerns lessen significantly if these concerns do not align or  
20 are attenuated. See Kamen, 500 U.S. at 98; Ford, 154 F.3d at  
21 616.

22 Determining the purposes of the hanging paragraph is not an  
23 easy or a certain task. In reviewing the words that Congress  
24 used, it is essential to consider "the language itself, the  
25 specific context in which that language is used, and the broader  
26 context of the statute as a whole." Robinson v. Shell Oil Co.,  
27 519 U.S. 337, 341 (1997). If the interpretation of statutory  
28 language is not clear from the plain meaning of the words used,



1 the statute's context within the overall statutory framework  
2 should be examined, with appropriate consideration of the  
3 legislative history. Davis v. Mich. Dept. of Treasury, 489 U.S.  
4 803, 809 (1989) ("[S]tatutory language cannot be construed in a  
5 vacuum. It is a fundamental canon of statutory construction that  
6 the words of a statute must be read in their context and with a  
7 view to their place in the overall statutory scheme.") (Citation  
8 omitted).

9 With those principles in mind, the relevant language of the  
10 hanging paragraph is, "For purposes of paragraph [1325(a)](5),  
11 section 506 shall not apply to a claim described in that  
12 paragraph if the creditor has a purchase money security interest  
13 securing the debt that is the subject of the claim...." (emphasis  
14 added). Congress did not state specifically that the hanging  
15 paragraph applied to a claim or debt "or any part or portion" of  
16 either. Neither did Congress specify that the hanging paragraph  
17 could be applied only to the "entire" claim or debt. As  
18 indicated above, the hanging paragraph does not direct courts to  
19 apply the UCC, or any other statute, to interpret the scope of  
20 "purchase money security interest."

21 From the language of the hanging paragraph itself and its  
22 limited legislative history,<sup>23</sup> it appears that the hanging  
23 paragraph was designed to combat a particular perceived abuse by

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24  
25 <sup>23</sup> Judge Lundin has examined in detail the hanging  
26 paragraph's legislative history. See his addendum in In re  
27 Hayes, 376 B.R. at 655, 676-684 (Bankr. M.D. Tenn. 2007). See  
28 also William C. Whitford, A History of the Automobile Lender  
Provisions of BAPCPA, 2007 U. ILL. L. REV. 143. A shorter  
description is Richardo I. Kilpatrick, Selected Creditor Issues  
under the Bankruptcy Abuse Prevention and Consumer Protection Act  
of 2005, 79 AM. BANKR. L.J. 817, 834-35 (2005).

1 debtors in chapter 13: purchasing a car shortly before a chapter  
2 13 bankruptcy filing and then taking advantage of the substantial  
3 depreciation that occurs immediately after a new car is driven  
4 off the lot. As summarized in Pajot:

5 Prior to BAPCPA, vehicle financiers could be harmed by a  
6 debtor who acquired a vehicle in the months leading up  
7 to bankruptcy, then filed bankruptcy and crammed the  
8 creditor's claim down to the collateral value on the  
9 date of filing. Due to the rapid depreciation of motor  
10 vehicles the moment they leave the dealer's lot,  
11 debtors could often reap a benefit by cramming down the  
12 debt, only paying a secured claim equal to the  
13 depreciated value of the car ... In enacting the  
14 hanging paragraph, Congress fixed this disparity to  
15 ensure that debtors could not load up on  
16 vehicle-secured debt pre-petition only to cram it down  
17 to the collateral value in bankruptcy.

18 371 B.R. at 159. See In re Lavigne, 2007 WL 3469454 at \*11.

19 This purpose, to prevent abusive use of the Bankruptcy  
20 Code's treatment of secured claims in chapter 13, is a far cry  
21 from Article 9's effort to meet commercial expectations when  
22 vendors sell new goods to debtors or to spare the filing system  
23 from endless consumer filings. It calls for an independent look  
24 at the options available to treat the non-PMSI (but still  
25 secured) portion of car debt in chapter 13.

## 26 2. *The Options*

27 Once a portion of the debt securing a car loan is found not  
28 to be secured by a purchase money security interest, the issue  
29 becomes how to treat the difference. As indicated above, the UCC  
30 defaults in nonconsumer cases to the Dual Status Rule. Com. 7a,  
31 UCC § 9-103. Many courts, however, have adopted the  
32 Transformation Rule, or something like it, in recognition of the  
33 narrow purposes and preferences served by the purchase money  
34 concept.

1           a.    Transformation Rule

2           “The ‘transformation rule’ provides that when a transaction  
3 contains both purchase money and non-purchase money obligations,  
4 the entire transaction is transformed into a non-purchase money  
5 obligation.” In re Burt, 378 B.R. 352, 359 n.34 (Bankr. D. Utah  
6 2007). Courts that have applied the Transformation Rule have  
7 generally held that the hanging paragraph does not afford any  
8 protection against cramdown of the secured creditor’s claim. See  
9 In re Blakeslee, 377 B.R. at 730; In re Price, 363 B.R. at 746.

10           The Transformation Rule enjoyed some support in the  
11 bankruptcy context before Congress adopted the hanging paragraph.  
12 See, e.g., In re Freeman, 956 F.2d 252 (11th Cir. 1992) (cross-  
13 collateralizing of PMSI collateral with non-PMSI collateral  
14 resulted in entire collateral being non-PMSI; lender abusing  
15 ability to perfect PMSI in consumer goods without filing); see  
16 also CLARK & CLARK, supra, at ¶ 12.02[2]. But cases such as  
17 Freeman attempt to stop abusive use of Article 9. There, the  
18 lender sold tools to the debtor and took a security interest in  
19 those tools to secure the unpaid purchase price. Without more,  
20 that should have created a purchase money security interest. But  
21 the lender also secured some prior, unrelated, debt with the new  
22 tools. It later claimed that the interest in tools was perfected  
23 without the need of a financing statement. The court found that  
24 this attempt to secure antecedent debt justified transforming the  
25 entire debt into nonpurchase money debt. Freeman, 956 F.2d at  
26 255.

27           An argument might be made that financing negative equity is  
28 no different from what the lender in Freeman did. After all,

1 financing negative equity is essentially identical to rolling  
2 existing debt into the financing offered to obtain the car. But  
3 in the typical negative equity situation, there is no ulterior  
4 motive or benefit present. Here, as in most negative equity  
5 situations, there is no doubt that all necessary steps to perfect  
6 the security interest were taken, and they were made public by  
7 virtue of their notation on the car's certificate of title.

8 At least two recent cases apply the Transformation Rule, or  
9 something like it, to security interests secured by negative  
10 equity obligations. In re Mitchell, 379 B.R. at 140-41; In re  
11 Sanders, 377 B.R. at 855. Mitchell and Sanders focus on the  
12 phrase "if the creditor has a purchase money security interest  
13 securing the debt that is the subject of the claim." Their  
14 reasoning is that Congress's use of the conditional "if" rather  
15 than more flexible language such as "to the extent," coupled with  
16 the omission of any quantifying modifier to the word "debt," for  
17 example, "part of" the debt, requires an absolute result,  
18 mandating application of the Transformation Rule, or something  
19 like it, rather than the Dual Status Rule.<sup>24</sup>

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20  
21 <sup>24</sup> In yet another analytical variation, In re Westfall, 376  
22 B.R. 210 (Bankr. N.D. Ohio 2007) used the "excluded purpose"  
23 doctrine of federal statutory interpretation to conclude that it  
24 was not appropriate to look to state law to ascertain whether the  
25 Transformation Rule or the Dual Status Rule should apply to  
26 determine the impact on a PMSI when part of the subject debt is  
27 not a purchase money obligation. "Excluded purpose means that a  
28 state statute should not serve as a federal rule of decision if  
the federal purpose was excluded from the state law. That is the  
case in the state law definition of purchase money." In re  
Westfall, 376 B.R. at 216-17. Applying this rule, the court  
observed that Official Comment 8 expressly provides that the  
state law definition of PMSI was not meant to apply to bankruptcy  
law. Without analyzing the language of the hanging paragraph,

(continued...)

1           These approaches, however, are not entirely satisfactory.  
2 Sanders and Mitchell assume that exegesis of the hanging  
3 paragraph reveals that Congress intended mixed or hybrid security  
4 interests securing one claim to be disqualified from receiving  
5 the benefits of the hanging paragraph. In re Sanders, 377 B.R.  
6 at 860-64 & n.21; In re Mitchell, 379 B.R. at 141-142. This  
7 analysis is doubtful for at least two reasons: first, the hanging  
8 paragraph is not a text that lightly gives up its meaning, let  
9 alone a plain meaning, and the use of standard interpretive  
10 conventions is not likely to yield a canonical reading strong  
11 enough to support such a drastic rule. Second, and more  
12 important, the analysis turns on the assumption that "debt"  
13 refers to a unitary concept that cannot be divided.

14           But the rest of the Code belies this assumption, as shown by  
15 § 506(b) and other similar sections that slice and dice debts to  
16 give different amounts different treatment. Put another way,  
17 Sanders and Mitchell ignore that a creditor may have several  
18 secured claims securing one debt if the debt is secured by more  
19 than one type of collateral. We choose here to interpret the  
20 hanging paragraph and § 1325(a) to mean that a lender has several  
21 claims, one secured by a PMSI, and the other not.

22                           b. Dual Status Rule

23           The state law Dual Status Rule recognizes that PMSIs may be  
24 divided, and that a secured obligation may be fractionalized,  
25 with one part secured by a PMSI and another part secured by a  
26

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27                           <sup>24</sup> (...continued)  
28 the court "adopted" the Dual Status Rule because "[s]imply,  
application of the transformation rule is too severe." Id. at  
219.

1 standard security interest. The treatment accorded each thus  
2 follows these characterizations.

3 Bankruptcy law treats claims similarly. Most famously,  
4 § 506(a) bifurcates claims into secured and unsecured claims  
5 depending on the value of the collateral. Similar treatment of  
6 secured claims that include negative equity - that the entire  
7 claim is secured, with only part of it being secured by a PMSI -  
8 is easily applied here. And many courts have done so, albeit  
9 under the guise of borrowing state law rather than fashioning a  
10 uniform federal rule. See In re Hernandez-Simpson, 369 B.R. at  
11 46; In re Lavigne, 2007 WL 3469454 at \*1 n.1; In re Johnson, 380  
12 B.R. at 250; Conyers, 379 B.R. at 582; In re Hayes, 376 B.R. 655,  
13 676 (Bankr. M.D. Tenn. 2007); In re Westfall, 376 B.R. at 220-21;  
14 In re Honcoop, 377 B.R. 719 (Bankr. M.D. Fla. 2007); In re Pajot,  
15 371 B.R. at 163; In re Acaya, 369 B.R. at 571.

16 These courts acknowledge that without any creditor action to  
17 be deterred or narrow policy goal to be vindicated, there is  
18 little reason to prefer something like the Transformation Rule,  
19 and in so doing echo the holdings of other federal cases  
20 construing "purchase money security interest" in other provisions  
21 of the Code. See, e.g., In re Billings, 838 F.2d 405 (§ 522(f));  
22 In re Pan Am Corp., 124 B.R. 960, 970-72 (Bankr. S.D.N.Y.), aff'd  
23 mem., 125 B.R. 372 (S.D.N.Y.), aff'd, 929 F.2d 109 (2d Cir.),  
24 cert. denied, 500 U.S. 946 (1991) (former § 1110).

25 Indeed, the Dual Status Rule, as the default rule under  
26 Article 9, essentially captures both the lender's reasonable  
27 expectations and the debtor's economic situation, and is  
28 consistent with the apparent purpose of the hanging paragraph.

1 Hence, in the context of the hanging paragraph, we are persuaded  
2 that the Dual Status Rule should be applied as the federal  
3 rule.<sup>25</sup>

4 The Dual Status Rule gives lenders a PMSI equal to the new  
5 value financed (or at least its value at filing) and a regular  
6 security interest for the balance. While this result raises  
7 issues of allocation of any payments since purchase,<sup>26</sup> an issue  
8 not present in this record, it ensures that lenders who do not  
9 finance negative equity receive the same treatment as lenders who  
10 assume the debtor's outstanding deficiencies. If the protections  
11 of the hanging paragraph are focused only on the new value  
12 extended, then car lenders do not have incentives to finance  
13 negative equity in order to receive better treatment in  
14 bankruptcy.

15 Similarly, adopting the Dual Status Rule would treat debtors  
16 who contract separately to pay off a deficiency on a trade-in the  
17 same as those who roll that deficiency into the new car purchase.  
18 It would ensure that whether assumption of unsecured debt is paid  
19 in full in a chapter 13 plan turns not on the form in which the  
20 debt was satisfied but on the substance of the transaction.

---

22 <sup>25</sup> The difference between adopting the Dual Status Rule as  
23 a uniform federal rule, and borrowing it from the UCC, is that we  
24 would apply the Dual Status Rule even if, under the majority  
25 version of UCC § 9-103(h), a state decided to adopt the  
26 Transformation Rule in negative equity situations.

27 <sup>26</sup> To further complicate matters, two states have adopted  
28 nonuniform variations to their versions of Article 9 to specify  
definite rules for the allocation of consumer payments.  
Connecticut and Tennessee have changed their versions of § 9-103  
to provide for consumer-favorable presumptions in the application  
of payments on consumer PMSIs. See, e.g., CONN. GEN. STAT. ANN.  
§ 42a-9-103a(e) (2) (2008); TENN. CODE ANN. § 47-9-103(e) (2) (2008).

1           These reasons make the Dual Status Rule preferable under the  
2 hanging paragraph for situations such as those present here.  
3 Accordingly, we adopt it.

4 **VI. Conclusion**

5           Penrod financed about \$7,100 of negative equity when she  
6 purchased her Taurus. In other words, when Americredit and its  
7 predecessor financed Penrod's purchase, they assumed and paid off  
8 her prior lender's unsecured claim for that amount.

9           Americredit now wants to treat its entire claim as subject  
10 to the hanging paragraph of § 1325(a), including the portion  
11 represented by its assumption of Penrod's unsecured debt. We  
12 disagree and hold that the portion of Americredit's collateral  
13 securing Penrod's negative equity is not a purchase money  
14 security interest within the meaning of the hanging paragraph.

15           That does not mean, however, that none of Americredit's  
16 security interest is purchase money. We reject the  
17 Transformation Rule and adopt the Dual Status Rule. Under that  
18 rule, Americredit receives purchase money status for that portion  
19 of its collateral not allocable to negative equity.

20           This is exactly the result reached by the bankruptcy court.  
21 We therefore AFFIRM.