

JOURNAL

AMERICAN BANKRUPTCY INSTITUTE

Issues and Information for Today's Busy Insolvency Professional

Negative Equity for "910-Day" Vehicle Purchase Receiving Positive Treatment for Creditors

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Bankruptcy Courts have increasingly been faced with the issue of how to address negative equity in conjunction with the valuation of "910-day" vehicles. As the reader is undoubtedly aware, treatment of such vehicles is addressed in the "hanging paragraph" under 11 U.S.C. §1325(a), which provides in pertinent part:

[S]ection 506 [of the Bankruptcy Code] 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[s] preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle...acquired for the personal use of the debtor.



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The cases reviewing the negative equity issue generally have the following fact pattern: (1) debtor and creditor enter into an agreement to finance a motor vehicle; (2) at the same time, debtor has a vehicle to trade-in;

(3) the trade-in value is less than the amount debtor owes for the trade-in vehicle; (4) the agreement ultimately reached between debtor and creditor includes financing for the "negative equity" of the trade-in vehicle; and finally (5) within 910-days of purchasing the new vehicle, debtor files for bankruptcy. The parties to these cases are generally

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willing to agree that the collateral is a motor vehicle acquired for personal use within the 910 days preceding the bankruptcy filing. The parties will not, however, typically agree on whether the negative equity is included within the definition of "purchase money security interest" such that the hanging paragraph under 11 U.S.C. §1325(a) precludes bifurcation of the creditor's claim into secured and unsecured portions under 11 U.S.C. §506. Although courts have taken diverging approaches, it appears a majority is starting to decide in favor of

the price of the collateral or for value given to enable the debtor to acquire rights in or use of the collateral if the value is in fact so used." To gain a greater understanding of the phrase "value given to enable," many courts have turned to comment 3 of U.C.C. §9-103. *See, e.g., GMAC v. Peaslee*, 373 B.R. at 258. Comment 3 states:

[T]he definition of "purchase-money obligation," the "price" of collateral or the "value given to enable" includes obligations for expenses incurred in connection with acquiring rights in the collateral, sales taxes, duties, finance charges, costs of storage in transit, demurrage, administrative charges, expense of collection and enforcement, attorney's fees and other similar obligations.

U.C.C. §9-103 cmt. 3. Reviewing this

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the creditors.

The Code does not define "purchase money security interest." Therefore, courts must look to state law for guidance, and in particular the state's version of the Uniform Commercial Code (UCC). *See, e.g., GMAC v. Peaslee*, 373 B.R. 252, 257 (W.D.N.Y. 2007) (citations omitted).¹ For purposes of this analysis, a security interest in goods is a purchase money security interest if the goods are purchase money collateral. U.C.C. §9-103(b). Purchase money collateral includes goods securing a purchase money obligation. U.C.C. §9-103(a)(1). A purchase money obligation is one that is "incurred as all or part of

language, one court adequately summarized the common-sense answer to the question of whether negative equity should be included in a purchase money security interest by stating: "If the buyer and seller agree to include the payoff of the outstanding balance on the trade-in as an integral part of their transaction...it is in fact difficult to see how that could *not* be viewed as [an expense incurred in acquiring rights in the vehicle]." *GMAC v. Peaslee*, 373 B.R. at 259 (emphasis in original).

Not all courts have agreed with this reasoning. An Oregon court recently determined that negative equity was not part of the purchase money obligation. *In re Riach*, 2008 WL 474384 (Bankr. D. Or. Feb. 19, 2008). As a result of this

¹ For simplicity, this article will cite to the applicable provisions of the UCC, instead of a particular state's version of the UCC.

finding, the court was forced to address how to characterize the secured party's claim. The court noted that two rules have developed for such situations, the "dual status" rule and the "transformation" rule. *Id.* at *4. Under the former, a security interest is a purchase money security interest to the extent the collateral secures unpaid purchase money and a general security interest for that portion of the obligation unrelated to the purchase. *Id.* Under the "transformation" rule, if there is any aspect of the security interest that is not related to the purchase money security interest, then the creditor loses its entire purchase. *Id.* The court ultimately adopted the "dual status" rule. *Id.* Interestingly, the court also found that the service contract was part of the sale price and thus part of the purchase money obligation. *Id.*

In Florida, the matter appears to be a bit more complicated. One bankruptcy court has determined that when negative equity and gap insurance are included in the purchase price, the nonpurchase money negative equity transforms the entire claim into a nonpurchase money security interest. *In re Blakeslee*, 377 B.R. 724, 728-30 (Bankr. M.D. Fla. 2007). In an opinion dated the same day, that court found that with respect to gap insurance only, the court has the discretion to apply the dual status rule and reduce the purchase money secured claim accordingly. *In re Honcoop*, 377 B.R. 719, 724 (Bankr. M.D. Fla. 2007). More recently, another bankruptcy court in Florida's Middle District found the reasoning in *GMAC v. Peaslee* persuasive and held that negative equity is included in creditors' purchase money security interests. *In re Schwalm*, 380 B.R. 630, 635 (Bankr. M.D. Fla. 2008).

The national trend is headed in the direction of including negative equity and other costs in a debtor's purchase money obligations. *In re Vinson*, 2008 WL 319678 (Bankr. D. S.C. 2008) (citing *GMAC v. Peaslee*, 373 B.R. 252, 262 (W. D.N.Y. 2007); *Graupner v. Nuvel Credit Corp.*, 2007 WL1858291, at *2 (M.D. Ga. June 26, 2007); *In re Schwalm*, 380 B.R. 630, 635 (Bankr. M.D. Fla. 2008); *In re Weiser*, 381 B.R. 263 (Bankr. W.D. Mo. 2007); *In re Wall*, 376 B.R. 769, 771 (Bankr. W.D.N.C. 2007); *In re Cohrs*, 373 B.R. 107, 109-10 (Bankr. E.D. Cal. 2007); *In re Petrocci*, 370 B.R. 489, 504 (Bankr. N.D.N.Y. 2007)). See also *In re Gray*, 382 B.R. 438 (Bankr. E.D. Tenn. 2008); *In re Dunlap*, 383 B.R. 113

(Bankr. E.D. Wis. 2008). The *Vinson* court went on to cite provisions in the legislative history behind 11 U.S.C. §1325 for additional support in protecting certain secured creditors and including negative equity in a purchase money security interest. *In re Vinson*, 2008 WL 319678 at *3.

A thorough analysis supporting this position appears in *In re Weiser*, 381 B.R. 263 (Bankr. W.D. Mo. 2007). There, the court offered an explanation for refusing to apply either the transformation rule or the dual status rule. It noted that such rules are typically applied when lenders refinance old collateral and add new collateral. *Id.* at 270. That situation is of course not present in the negative-equity context because only the new car secures the obligation. *Id.*

More recently, the Eastern District of Virginia came to the same conclusion, noting it was joining the "emerging majority interpretation of purchase money security interest[s] to encompass negative equity." *GMAC v. Horne*, 2008 WL 2662024 (E.D. Va., July 3, 2008). In so doing, the court relied on the statutory text, official comment to the UCC, decisional law (including those opinions referenced above) and the underlying purpose of the hanging paragraph. *Id.* at *5-11. But the court declined to include gap insurance within the contemplation of the terms "price" or "value given to enable." *Id.* at *12.

Whether and to what extent negative equity, gap insurance and other fees are included within the definition of purchase money security interest is an area of law developing at a rapid rate. Although gap insurance is addressed in a less uniform manner, courts are starting to agree that negative equity should be included in a debtor's purchase money obligations. Nonetheless, prescient creditors will be sure to continue monitoring the courts' opinions in each state they operate. ■

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