(MIS)USE OF STATE LAW IN BANKRUPTCY: THE HANGING PARAGRAPH STORY

JULIET M. MORINGIELLO *

This Article addresses the use of state law in bankruptcy in the context of the controversial "hanging paragraph" of the Bankruptcy Code, which was added to the Code by the 2005 amendments. The hanging paragraph appears to grant undersecured car lenders full payment in Chapter 13 bankruptcy cases, treatment that gives such lenders better treatment than other secured lenders. The provision is particularly controversial when applied to negative equity financing. Negative equity financing is provided by lenders when a car buyer offers a trade-in vehicle that is worth less than the outstanding loan that it secures. When a lender makes a negative equity loan, it is undersecured on the day the loan is made.

Whether a negative equity loan is entitled to full payment under the hanging paragraph turns on the definition of "purchase-money security interest," a term that is used but not defined in the Bankruptcy Code. The majority of all courts that have addressed the issue, as well as all nine of the Circuit Courts of Appeal that have done so, considered the term to be defined by state law, relying on a 1979 Supreme Court case, *Butner v. United States*. In this Article, I explain why state law should not define the term "purchase-money security interest" for hanging paragraph purposes.

To do so, I propose a framework for analysis that is based on the difference between bankruptcy entry rights and bankruptcy exit rights to show that an analysis that relies only on *Butner* to determine the appropriate use of state law in bankruptcy is incomplete. This entry/exit framework requires a detailed examination of the package of rights inherent in any property interest in order to determine whether that right is one that bankruptcy policy should respect. I then explain that because a purchase-money security interest in a consumer good (such as a car subject to the hanging paragraph) refers only to a bankruptcy exit right, it should be defined according to federal law, following another 1979 Supreme Court case, *United States v. Kimbell Foods*. I conclude by proposing a bankruptcy policy-based definition of purchase-money security interest for hanging paragraph purposes.

* Professor, Widener University School of Law. Many thanks to Ashley Oakey, Widener University School of Law Class of 2012, for her able and enthusiastic research assistance, and to David Gray Carlson, Bill Henning, and Bill Reynolds for their thoughtful comments on drafts of this Article.

INTRODUCTION

The Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) amended the Bankruptcy Code ("Code") in 2005. In the years since its enactment, scholarly literature has been filled with the story of BAPCPA's creation. It is a story of creditor influence resulting in a pro-creditor bias,[1] and a story of shoddy legislative drafting.[2] The Supreme Court has already taken three opportunities to determine the meaning of various BAPCPA provisions,[3] and there is no doubt that the Court will have others. An open BAPCPA question is one that appears simple: what is the extent of a purchase-money security interest? Wrapped in this deceptively simple query is a broader question of bankruptcy policy: when should bankruptcy courts use state law to define undefined terms in the Code?

A particularly poorly-drafted provision of BAPCPA is its "hanging paragraph." So named because it appears at the end of § 1325(a)(9) without an identifying number,[4] this hanging paragraph grants special protections to creditors who hold purchase-money security interests in automobiles acquired for the personal use of the debtor, but it does not define the term "purchase-money security interest." Since the enactment of BAPCPA, the absence of such a definition has led to voluminous litigation over whether a lender who extends "negative equity" financing (financing that includes both the purchase price of the automobile and the payoff of the buyer's old car loan) is entitled to purchase-money status, and thus special protection, for both the purchase price of the car and the payoff of the old debt. Although the

---

1. *See, e.g.*, Jean Braucher, Rash *and Ride-Through Redux: The Terms for Holding on to Cars, Homes and Other Collateral under the 2005 Act*, 13 AM. BANKR. INST. L. REV. 457, 457 (2005) ("[T]he credit industry apparently paid for the initial drafting of [BAPCPA]."); Margaret Howard, *Exemptions under the 2005 Bankruptcy Amendments: A Tale of Opportunity Lost*, 79 AM. BANKR. L.J. 397, 398 (2005) (describing the title of BAPCPA as "a misnomer if ever there was one"); Henry J. Sommer, *Trying to Make Sense out of Nonsense: Representing Consumers under the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005,"* 79 AM. BANKR. L.J. 191, 191 (2005) ("There is no doubt that bankruptcy relief will be more expensive for almost all debtors, less effective for many debtors, and totally inaccessible for some debtors as a result of [BAPCPA].").

2. *See, e.g.*, Jean Braucher, *A Guide to Interpretation of the 2005 Bankruptcy Law*, 16 AM. BANKR. INST. L. REV. 349, 349 (2008) (describing the legislation as "a defectively designed and poorly drafted mess"); Sommer, *supra* note 1, at 191–92.

3. *Ransom v. FIA Card Servs., N.A.*, 131 S. Ct. 716, 721 (2011) (addressing the calculation of the debtor's expenses for the purpose of determining disposable income under BAPCPA); *Hamilton v. Lanning*, 130 S. Ct. 2464, 2471–74 (2010) (addressing the calculation of a debtor's projected disposable income for Chapter 13 purposes under BAPCPA); *Milavetz, Gallop & Milavetz, P.A. v. United States*, 130 S. Ct. 1324, 1331–33 (2010) (addressing whether attorneys are included within the definition of "debt relief agencies" under BAPCPA and whether BAPCPA therefore prevented them from giving certain types of legal advice).

4. As some courts have done, I will cite the hanging paragraph as 11 U.S.C. § 1325(a)(*) (2006). *See, e.g.*, *In re Pruitt*, 401 B.R. 546, 550 (Bankr. D. Conn. 2009).

federal circuit courts of appeal are split eight to one on the issue, in October 2011, the Court denied certiorari in the Ninth Circuit case, *Americredit Financial Services, Inc. v. Penrod*.[5]

The Supreme Court provides no reasons for its denial of certiorari. One can assume, however, that one reason it denied certiorari in *Penrod* is that the Court viewed the question as one of state law, rather than one of conflicting interpretations of federal law.[6] This refusal to hear the case is understandable; all of the circuit courts of appeal based their holdings on state law.[7] As I will explain in this Article, however, state law has no role in interpreting the term "purchase-money security interest" for the purpose of the hanging paragraph, and the Court was wrong to refuse the chance to inject much needed clarity into a poorly-drafted Code provision.

This Article expands on a suggestion I made more than a decade ago. In an article published in the *Washington University Law Quarterly*, I discussed § 522(f) of the Code, which allows a debtor to avoid a nonpossessory, non-purchase-money security interest in certain household goods.[8] In that article, I argued that because a secured creditor's purchase-money status with respect to consumer goods is meaningless outside of bankruptcy, federal law, rather than state law as codified in the respective state enactments of the Uniform Commercial Code (UCC), should define the term "purchase-money security interest" when the Code singles out such interests for special treatment.[9] In this Article, I take a more theoretical approach to the use

5. *Americredit Fin. Servs., Inc. v. Penrod* (*In re Penrod*), 611 F.3d 1158 (9th Cir. 2010), *cert. denied*, 132 S. Ct. 108 (2011).

6. *See* Daniel A. Austin, *Bankruptcy and the Myth of "Uniform Laws,"* 42 SETON HALL L. REV. 1081, 1139 (2012) ("A major factor in granting certiorari . . . is uniformity in the application of federal law."). Indeed, the brief opposing certiorari in *Penrod* stressed the fact that every circuit court of appeals relied on state, not federal, law to determine the extent of a purchase money security interest for the purpose of the hanging paragraph. *See* Brief in Opposition on Petition for Writ of Certiorari to the U.S. Court of Appeals for the Ninth Circuit at 12, *Americredit Fin. Servs., Inc. v. Penrod*, 132 S. Ct. 108 (2011) (No. 10-1443), 2011 WL 3252812 at *12.

7. *Penrod*, 611 F.3d at 1161; *Nuvell Credit Corp. v. Westfall* (*In re Westfall*), 599 F.3d 498, 502 (6th Cir. 2010); *In re Howard*, 597 F.3d 852, 855 (7th Cir. 2010); *Reiber v. GMAC, LLC* (*In re Peaslee*), 585 F.3d 53, 56 (2d Cir. 2009); *Ford Motor Credit Co. v. Dale* (*In re Dale*), 582 F.3d 568, 573 (5th Cir. 2009); *Ford Motor Credit Co. v. Mierkowski* (*In re Mierkowski*), 580 F.3d 740, 742 (8th Cir. 2009); *Ford v. Ford Motor Credit Corp.* (*In re Ford*), 574 F.3d 1279, 1283 (10th Cir. 2009); *In re Price*, 562 F.3d 618, 623–24 (4th Cir. 2009); *Graupner v. Nuvell Credit Corp.* (*In re Graupner*), 537 F.3d 1295, 1301 (11th Cir. 2008).

8. *See* Juliet M. Moringiello, *A Tale of Two Codes: Examining § 522(F) of the Bankruptcy Code, § 9-103 of the Uniform Commercial Code and the Proper Role of State Law in Bankruptcy*, 79 WASH. U. L.Q. 863 (2001).

9. *Id.* at 882.

of state law to define undefined terms in the Code. To do so, I develop a framework that distinguishes "bankruptcy entry" rights from "bankruptcy exit" rights, and explain that although state law defines bankruptcy entry rights, federal law should always define bankruptcy exit rights.

To develop my arguments, in Part I, I will explain the hanging paragraph and the lending practices that necessitate a clear definition of the term "purchase-money security interest." In Part II, I will discuss the decisions of the circuit courts that have addressed the negative equity issue, stressing the emphasis that those courts placed on state law. In Part III, I develop my bankruptcy entry/bankruptcy exit framework, using two Supreme Court cases, *Butner v. United States*[10] and *United States v. Kimbell Foods Inc.*,[11] which, while often cited for the proposition that courts must use UCC definitions of commercial terms when the Code leaves such terms undefined, do not in fact require that bankruptcy courts resort to Article 9 of the UCC to define purchase-money security interests. I then explain why purchase-money status is a bankruptcy exit right. Because federal law can incorporate state law unless doing so would contravene a federal policy, in Part IV, I discuss the language and legislative history of the hanging paragraph to demonstrate that Congress intended that the hanging paragraph be applied uniformly. In Part V, I explain why the UCC definition of "purchase money" is irrelevant to hanging paragraph transactions. In Part VI, I discuss the Bankruptcy Appellate Panel (BAP) opinion in *Penrod*[12] to demonstrate that a bankruptcy entry/bankruptcy exit analysis would have reached the same result while stressing that the definition of purchase money should be a matter of federal, rather than state law. I conclude by urging courts to abandon the assumption that state law should define property rights for all bankruptcy purposes.

I. The Hanging Paragraph and Negative Equity Financing

A. Car Loans in Bankruptcy, Then and Now

Before the enactment of BAPCPA, all secured creditors in Chapter 13 bankruptcy cases, with the exception of home mortgage creditors, received the same treatment. Chapter 13, the rehabilitation chapter for individuals, allows an individual debtor to keep her property and pay

---

10. 440 U.S. 48 (1979).

11. 440 U.S. 715 (1979).

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

her debts using future income according to a three-to-five year plan approved by the bankruptcy court.[13]

Before BAPCPA, the Code granted debtors three options for dealing with their secured creditors (other than home mortgage creditors).[14] A debtor could surrender the collateral to the creditor, obtain the creditor's agreement to her proposed treatment of the debt, or allow the creditor to retain its lien on the collateral and pay the creditor the present value of its secured claim over the course of the plan.[15] If the debtor chose the third option, known as "cram down," the debtor could bifurcate an undersecured claim into two claims: a secured claim and an unsecured claim. Because a creditor's secured claim in bankruptcy is equal to the value of the collateral securing the claim, an undersecured creditor was entitled to full payment of the value of its collateral and payment of its remaining deficiency claim on a *pro rata* basis with the other unsecured claims against the debtor.[16] The cram down distribution reflects the creditor's state law entitlement because a secured creditor who forecloses on collateral worth less than the outstanding loan amount will receive the value of the collateral from the sale of the collateral and will be left with an unsecured claim for the deficiency.[17]

Automobile lenders did not like that treatment. Cars depreciate rapidly after purchase, rendering many car lenders undersecured shortly after their loans are made. Many of these lenders are therefore

---

13. CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY § 12.1, at 1202 (2d ed. 2009).

14. As a practical matter, few undersecured debts can be bifurcated today in Chapter 13. Most individuals who do not have their own businesses have only two types of secured clams: the home mortgage and the car loan. *See* David Gray Carlson, *Cars and Homes in Chapter 13 after the 2005 Amendments to the Bankruptcy Code*, 14 AM. BANKR. INST. L. REV. 301, 302 (2006) ("Surely the two most important secured lenders in chapter 13 bankruptcy cases are the home mortgage lender and the car lender."). A home mortgage loan cannot be modified in Chapter 13, 11 U.S.C. § 1322(b)(2) (2006), the Supreme Court has interpreted modification to include loan bifurcation, *Nobelman v. American Savings Bank*, 508 U.S. 324, 332 (1993), and the hanging paragraph forbids the bifurcation of purchase-money car loans made within 910 days before the petition. § 1325 (a)(*).

15. § 1325(a)(5).

16. § 506(a).

17. U.C.C. § 9-615(d) (2012–13). Generally, bankruptcy law respects state law property entitlements. *Butner v. United States*, 440 U.S. 48, 55 (1979) ("Unless some federal interest requires a different result, there is no reason why [property] interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.").

undersecured when their borrowers file for bankruptcy.[18] The lenders successfully lobbied for special treatment in BAPCPA, resulting in the controversial, poorly-drafted, and pro-automobile creditor "hanging paragraph."[19]

The hanging paragraph appears to treat some automobile lenders as fully-secured creditors regardless of the value of their collateral. I say "appears to treat" because of the hanging paragraph's cryptic drafting. The relevant portion of the hanging paragraph states that:

> For purposes of paragraph (5) [the paragraph setting forth the treatment of secured claims in a Chapter 13 plan], section 506 shall not apply to a claim described in that paragraph if the creditor has a purchase money security interest securing the debt that is the subject of the claim, the debt was incurred within the 910-day preceding the date of the filing of the [bankruptcy] petition, and the collateral for that debt consists of a motor vehicle . . . acquired for the personal use of the debtor.[20]

Section 506 does several things, and I will explain its overall role in the bankruptcy distribution scheme in Part IV below. Most importantly for hanging paragraph purposes, § 506 bifurcates an undersecured claim into a secured claim in the amount of the value of the collateral and an unsecured claim for the amount by which the outstanding loan amount exceeds the value of the collateral.[21]

Despite its poor drafting, the hanging paragraph is widely understood to prohibit the bifurcation of an undersecured purchase-money automobile loan into a secured and unsecured portion if the loan was made within 910 days before the debtor's bankruptcy petition (these loans are commonly known as "910 loans").[22] The

---

18. *See In re Pajot*, 371 B.R. 139, 159 (Bankr. E.D. Va. 2007) (contrasting rapidly depreciating automobile collateral with traditionally appreciating mortgage collateral).

19. *See generally* William C. Whitford, *A History of the Automobile Lender Provisions of BAPCPA*, 2007 U. ILL. L. REV. 143 (providing a history of the legislative process that resulted in the hanging paragraph).

20. 11 U.S.C. § 1325(a)(*).

21. § 506(a)(1).

22. *See, e.g.*, *In re Pruitt*, 401 B.R. 546, 561 (Bankr. D. Conn. 2009) ("The Hanging Paragraph achieves its goal of limiting Cram-Down in Chapter 13 by preventing the bifurcation . . . of . . . 910-Vehicle claims . . . .") (emphasis omitted); TABB, *supra* note 13, § 1.25, at 109; Braucher, *supra* note 2, at 401–02.

hanging paragraph thus treats those loans as fully secured, despite the fact that they are under-collateralized.[23]

The hanging paragraph therefore results in a great benefit to 910 lenders. Bankruptcy law guarantees most unsecured creditors the full payment of only the value of their collateral. Any amount by which the outstanding loan amount exceeds the value of the collateral is treated as an unsecured claim that is paid *pro rata* with all other unsecured claims, such as those of credit card issuers.[24] The hanging paragraph, however, grants undersecured 910 lenders full payment of the entire amount owed to them over the term of the Chapter 13 plan.

By excluding 910 loans from § 506, the hanging paragraph values a 910 lender's secured claim at the amount of the outstanding debt, regardless of the value of the collateral.[25] This interpretation reflects the legislature's stated goal in enacting the hanging paragraph—to protect car lenders who find themselves undersecured as a result of depreciation when car buyers file for bankruptcy within roughly two and one-half years after buying a car.[26] The legislative history of BAPCPA is scant, but it is clear that the legislature wanted to give special treatment to automobile lenders who extended the financing to allow customers to purchase new cars. But how much protection is too much protection?

B. And Then Came Negative Equity Financing

Today, lenders offer new and used car loans that are payable over as many as six years.[27] According to statistics published by the Federal

---

23. *See Pruitt*, 401 B.R. at 561–62 ("The hanging paragraph . . . creat[es] somewhat of a legal fiction that [910] claims are *fully and perfectly secured* even if, in actuality, they are under-collateralized.") (emphasis in original).

24. §§ 506(a), 1325(a)(4).

25. *Capital One Auto Fin. v. Osborn*, 515 F.3d 817, 820–21 (8th Cir. 2008); *In re Wright*, 492 F.3d 829, 830, 832 (7th Cir. 2007); Braucher, *supra* note 2, at 401–02; Carlson, *supra* note 14, at 303; Whitford, *supra* note 19, at 150.

26. Whitford, *supra* note 19, at 177–78 (explaining that the hanging paragraph was first introduced by Senator Spencer Abraham of Michigan at the behest of the automobile finance industry and that representatives of that industry had testified in favor of enhanced protections for automobile lenders because "they suffer the greatest losses on cramdown in the early years of the vehicles [sic] life when depreciation is the greatest").

27. *See, e.g.*, *Chase Auto Loan Rates*, CHASE, https://www.chase.com/online/auto-loan/auto-loan-rates-compare.htm (last visited Sept. 20, 2012) (offering a rate as low as 3.56% for a seventy-two month used car loan); *Used Car Loans*, CAPITALONE, http://www.capitalone.com/auto-financing/used-car-loans (last visited Sept. 4, 2012) (advertising a seventy-two month used car loan at an annual percentage rate of 5.09% with the caveat that a borrower's actual rate may be higher depending on her credit score; a thirty-six month used car loan on the same site carries

Reserve, the average maturity for new car loans in 2010 and 2011 was around six years.[28] A long repayment period increases the chances that the buyer will owe more than the car is worth for a long period of time. It also increases the likelihood that when the buyer needs to replace her car, the loan she obtained to purchase that car will exceed the value of the car.

The hanging paragraph is particularly controversial when applied to negative equity financing. A lender extends negative equity financing when a car buyer offers a trade-in vehicle that is encumbered by a security interest securing a debt that exceeds the value of the vehicle. This happens when the buyer has not repaid the loan he obtained to purchase his existing car and the car is worth less than the outstanding amount of the loan. The lender then finances not only the purchase of the new car, but also satisfies the debt owing on the trade-in vehicle. As a result, the loan for the new car is "underwater" (meaning that the loan amount exceeds the value of the collateral securing the loan) the moment that it is made and the borrower never has any equity in his new car.[29] According to a study released by the FDIC, thirty-eight percent of new car buyers in 2005, the year BAPCPA was enacted, had negative equity at trade-in.[30] In recent years, at least one-quarter of all new car loans have involved negative equity.[31]

---

a rate as low as 3.99%). But Chase's rate assumes that the borrower maintains a premier checking account at Chase, which carries a minimum twenty-five dollar monthly service fee if the average daily account balance is less than $15,000, agrees to automatic loan payment deduction, has an excellent credit history, and is financing no more than 95% of the value of the car. *Chase Checking Accounts*, CHASE, https://www.chase.com/online/Checking/ chase-checking-account.htm (last visited Sept. 20, 2012) (account details vary by location).

28. FED. RES., CONSUMER CREDIT: NOVEMBER 2011, http:// www.federalreserve.gov/releases/g19/20120109/g19.pdf.

29. JOHN W. VAN ALST, NAT'L CONSUMER LAW CTR., FUELING FAIR PRACTICES: A ROAD MAP TO IMPROVED PUBLIC POLICY FOR USED CAR SALES AND FINANCING 8 (2009), *available at* http://www.nclc.org/images/pdf/car_sales/report-fuelingfairpractices0309.pdf.

30. James A. Wilson, Jr. & Sandra L. DiChiara, *The Changing Landscape of Indirect Automobile Lending*, SUPERVISORY INSIGHTS, Summer 2005, at 30, *available at* http://www.fdic.gov/regulations/examinations/supervisory/insights/sisum05/article04_auto_lending.html.

31. According to Edmunds.com, the automobile shopping service, about 25% of new car sales in 2008 involved negative equity trade-ins, with buyers owing an average of more than $4400 over their car's value. Diane C. Lade, *Falling Auto Values Leave Buyers Trapped in Loans*, S. FLA. SUN-SENTINEL (Fort Lauderdale), Dec. 12, 1998, *reprinted at* Diane C. Lade, *"Upside-Down" Auto Loans*, DENVERPOST.COM (Dec. 15, 2008), http://www.denverpost.com/financialcrisis/ci_11232748. A 2008 report by Benchmark Consulting stated that more than 25% of new car transactions involved negative equity and that the average negative equity amount was $4250. RICHARD APICELLA & GEORGE HALLORAN, BENCHMARK CONSULTING INT'L, THE

Debtors saddled with negative equity 910 loans have argued that the inclusion of negative equity renders the entire loan non-purchase-money, thus removing the loan from the coverage of the hanging paragraph and allowing cram down to the value of the car.[32] Courts tend to reject this view, but some allow a negative equity loan to be treated as two loans: one for the purchase price of the car, subject to the hanging paragraph and thus exempt from cram down, and the other for the negative equity refinance, treated as an unsecured deficiency.[33] Lenders, on the other hand, believe that the payoff of negative equity should be considered part of the purchase price of a new vehicle, subjecting the entire loan to the hanging paragraph.[34] As I will discuss below, the appellate courts have overwhelmingly sided with the lenders, erroneously incorporating a state law definition of purchase money.

II. NEGATIVE EQUITY IN THE COURTS: PIGS GET FAT, BUT HOGS DO NOT GET SLAUGHTERED

Nine federal circuit courts of appeals have addressed the question of whether amounts advanced to satisfy negative equity loans constitute purchase money for the purpose of granting automobile lenders special priority under the Code. Remarkably, eight of those courts have answered "yes;"[35] the only court of appeals to reject the idea that the

---

RISING REPOSSESSION TIDE 2 (Apr. 2008), http://www.benchmark international.com/Articles/ TheRisingRepossessionTide.pdf. In recent years, the average loan-to-value ratio for new car loans has been as high as 95%. *See Terms of Credit at Commercial Banks and Finance Companies*, BOARD GOVERNORS FED. RES. SYS., http://www.federalreserve. gov/releases/g19/HIST/cc_hist_tc.html (last updated May 7, 2012).

32. *See, e.g.*, *Americredit Fin. Servs., Inc. v. Penrod* (*In re Penrod*), 392 B.R. 835, 839 (B.A.P. 9th Cir. 2008) (describing the bankruptcy court's rejection of the debtor's assertion that the entire loan was non-purchase-money); *In re Hall*, 400 B.R. 516, 518 (Bankr. S.D. W.Va. 2008).

33. *See, e.g.*, *In re Crawford*, 397 B.R. 461, 468 (Bankr. E.D. Wis. 2008); *In re Brodowski*, 391 B.R. 393, 403–04 (Bankr. S.D. Tex. 2008).

34. *See, e.g.*, *In re Mitchell*, 379 B.R. 131, 134 (Bankr. M.D. Tenn. 2007) (describing lender's argument that all of the amounts financed by the lender, including the negative equity payoff, were directly connected to the purchase price of the new vehicle and therefore the entire security interest was a purchase money security interest).

35. *Nuvell Credit Corp. v. Westfall* (*In re Westfall*), 599 F.3d 498, 500 (6th Cir. 2010); *In re Howard*, 597 F.3d 852, 858 (7th Cir. 2010); *Reiber v. GMAC, LLC* (*In re Peaslee*), 585 F.3d 53, 57 (2d Cir. 2009); *Ford Motor Credit Co. v. Dale* (*In re Dale*), 582 F.3d 568, 575 (5th Cir. 2009); *Ford Motor Credit Co. v. Mierkowski* (*In re Mierkowski*), 580 F.3d 740, 743 (8th Cir. 2009); *Ford v. Ford Motor Credit Corp.* (*In re Ford*), 574 F.3d 1279, 1285 (10th Cir. 2009); *In re Price*, 562 F.3d 618, 629–30

term "purchase money" could include negative equity financing was the Ninth Circuit.[36] As a result, in most circuits, a debtor who wants to keep her car after filing for bankruptcy is required to pay the loan in full, including the negative equity portion. In this Part, I explain the courts' use of state law to justify their holdings.[37]

A. Purchase Money Includes Negative Equity because the UCC Says So

Because the Code contains no definition of purchase-money security interest, the overwhelming majority of the courts that have confronted the negative equity issue have looked to Article 9 of the UCC for guidance. Most of those courts justify their reliance on Article 9 by citing the Supreme Court's statement in *Butner* that "[p]roperty interests are created and defined by state law."[38]

(4th Cir. 2009); *Graupner v. Nuvell Credit Corp.* (*In re Graupner*), 537 F.3d 1295, 1303 (11th Cir. 2008).

36. *Americredit Fin. Servs., Inc. v. Penrod* (*In re Penrod*), 611 F.3d 1158, 1164 (9th Cir. 2010). Although the Ninth Circuit acknowledged that it created a circuit split ("[w]e acknowledge that our decision creates a circuit split, and we do not do this lightly," *id.* at 1161), some believe that because the application of the hanging paragraph turns on the state law definition of "purchase money security interest," there is no circuit split. *See* Brief in Opposition on Petition for Writ of Certiorari to the U.S. Court of Appeals for the Ninth Circuit, *Americredit Fin. Servs., Inc. v. Penrod*, 132 S. Ct. 108 (2011) (No. 10-1443), 2011 WL 3252812.

37. To buttress their contention that negative equity financing is included in purchase money for hanging paragraph purposes, some courts also pointed to the popularity of negative equity financing in 2005—the year BAPCPA was enacted. *See* *Price*, 562 F.3d at 628; *Graupner*, 537 F.3d at 1303. One went so far as to say that giving special treatment to negative equity lenders "may be essential to the flourishing of the important market that consists of the sale of cars on credit." *Howard*, 597 F.3d at 858. This is a bit of an overstatement because, as mentioned above, negative equity financing was prevalent before the BAPCPA amendments.

38. *Butner v. United States*, 440 U.S. 48, 55 (1978). For opinions relying on this statement, see, *e.g.*, *Howard*, 597 F.3d at 855 ("[G]enerally and in the present setting the rights enforced in bankruptcy are rights created by state law."); *Westfall*, 599 F.3d at 502 ("[W]e generally assume that Congress has left the determination of property rights in the assets of a bankrupt's estate to state law . . . .") (internal quotation marks omitted); *Price*, 562 F.3d at 624 (applying a state law definition of purchase money security interest because "when determining the substance of property rights and security interests in bankruptcy, the basic federal rule is that state law governs") (internal quotation marks omitted); *Dale*, 582 F.3d at 573 ("It is common in the bankruptcy context to look to state law to define security interests . . . , the basic federal rule is that state law governs.") (internal quotation marks omitted); *Ford*, 574 F.3d at 1283 ("Property interests referred to in the Bankruptcy Code are generally defined by state law."); *Penrod*, 611 F.3d at 1161 ("In bankruptcy, property interests are usually defined by state law.").

Although the rule that purchase money includes amounts used to satisfy negative equity is found nowhere in the UCC, seven of the nine circuits that have addressed the negative equity issue found that the UCC does indeed require that sums attributable to negative equity be included in the definition of purchase money.[39] These courts based their holdings on section 9-103, the section that defines purchase-money security interest, and Official Comment 3 to that section.[40]

Before Article 9 of the UCC was revised in 2001, it contained a simple and elegant definition of purchase-money security interest. According to pre-revised Article 9, a security interest was a "purchase money security interest" to the extent that it was:

> (a) taken or retained by the seller of the collateral to secure all or part of its price; or
> (b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.[41]

The current version of the UCC uses far more complicated language to make the same point. Today, a security interest in goods is a purchase-money security interest "to the extent that the goods are purchase-money collateral with respect to that security interest."[42] Goods are "purchase-money collateral" if they secure "a purchase money obligation incurred with respect to that collateral" and a "purchase-money obligation" is "an obligation of an obligor incurred as all or part of the price of the collateral or for value given to enable the debtor to acquire rights in or the use of the collateral if the value is in fact so used."[43]

Under the UCC, therefore, either a seller (who advances the price) or a third-party lender (who advances value to enable the debtor to purchase) can have a purchase-money security interest in goods. The Official Comment to section 9-103 provides a nonexclusive list of the components of "price" and "value given to enable" the purchase of

---

39. *Westfall*, 599 F.3d at 504; *Peaslee*, 585 F.3d at 57; *Dale*, 582 F.3d at 575; *Ford*, 574 F.3d at 1285; *Mierkowski*, 580 F.3d at 743; *Price*, 562 F.3d at 626; *Graupner*, 537 F.3d at 1301.

40. *Westfall*, 599 F.3d at 504; *Peaslee*, 585 F.3d at 57; *Dale*, 582 F.3d at 575; *Ford*, 574 F.3d at 1285; *Mierkowski*, 580 F.3d at 743; *Price*, 562 F.3d at 626; *Graupner*, 537 F.3d at 1301.

41. U.C.C. § 9-107, 3A U.L.A. 526 (2002).

42. U.C.C. § 9-103(b)(1) (2012–13).

43. § 9-103(a). Although the language is far more complicated today, the more complicated language was inserted to clarify the rules regarding refinancing and add-on debt.

goods.[44] That list includes "obligations for expenses incurred in connection with acquiring rights in the collateral, sales taxes, duties, finance charges, interest, freight charges, costs of storage in transit, demurrage, administrative charges, expenses of collection and enforcement, attorney's fees, and *other similar obligations.*"[45] The Official Comment then limits the list by cautioning that the concept of "purchase-money security interest" requires a "close nexus between the acquisition of collateral and the secured obligation."[46]

The courts that hold that the UCC includes negative equity financing in its definition of purchase money focus on the "other similar expenses" language in the Official Comment. Courts base this holding on three misunderstandings. The first is that the drafters of Article 9 must have intended that the term "price" be broadly interpreted[47] to include not only those expenses that "*must* be paid to drive the car off the lot,"[48] but also all expenses that the debtor incurs to allow it to acquire the new vehicle because Official Comment 3's list of price and value components includes obligations in addition to the "actual cost"[49] or commonly understood price[50] of the vehicle. The second is that the UCC must be read *in pari materia* with state motor vehicle finance laws, which list the components of a vehicle's price.[51] Third, courts state that an expansive view of price furthers the stated UCC policy of facilitating the "continued expansion of commercial practices."[52] I address and challenge all of these assumptions below.

1. "PRICE" MUST BE BROADLY INTERPRETED TO INCLUDE NEGATIVE EQUITY BECAUSE OFFICIAL COMMENT 3 SAYS SO

According to this reasoning, because most debtors must satisfy the debt on their old cars before they buy new ones, negative equity

---

44. *Id.* cmt. 3.

45. *Id.* (emphasis added).

46. *Id.*

47. *Ford Motor Credit Co. v. Mierkowski* (*In re Mierkowski*), 580 F.3d 740, 742 (8th Cir. 2009).

48. *Ford Motor Credit Co. v. Dale* (*In re Dale*), 582 F.3d 568, 574 (5th Cir. 2009) (quoting *Graupner v. Nuvell Credit Corp.* (*In re Graupner*)), 537 F.3d 1295, 1302 (11th Cir. 2008).

49. *Reiber v. GMAC, LLC* (*In re Peaslee*), 913 N.E.2d 387, 389 (N.Y. 2009) (deciding question certified by the Second Circuit).

50. *In re Price*, 562 F.3d 618, 626 (4th Cir. 2009).

51. ABNER J. MIKVA & ERIC LANE, AN INTRODUCTION TO STATUTORY INTERPRETATION AND THE LEGISLATIVE PROCESS 24 (1997).

52. U.C.C. § 1-103 (2012–13).

financing is an expense incurred in purchasing a vehicle.[53] The Tenth Circuit went so far as to say that it could "discern no significant difference between the expense of discharging negative equity on a trade-in and some of the other examples listed in" Official Comment 3.[54] The Fourth Circuit identified the "pertinent feature" shared by the expenses listed in Official Comment 3 and negative equity financing: all of the expenses are "incurred in 'connection with' the acquisition of a new car—just like negative equity financing."[55]

Courts recognize that the Official Comment 3 list contains a limitation: the price and value components must have a close nexus to the acquisition of the collateral. To some courts, the fact that a buyer often will not be able to purchase a new car without satisfying trade-in debt provides such a nexus. The Seventh Circuit cited the fact that almost forty percent of car sales included negative equity financing in 2005 to support its observation that "wrapping negative equity into the purchase-money security interest is often necessary to enable the purchase of the car."[56] The Tenth Circuit relied on the same statistic to show that many new vehicle purchases would not occur without negative equity financing and therefore, the payoff of negative equity is part of the price of a new car.[57] The Sixth Circuit observed that "most new car sales are accompanied by trade-ins."[58] Because most car sales involve trade-ins, the court reasoned, negative equity financing is "vital to facilitating the transaction" and therefore fits within the meaning of "price" under Official Comment 3.[59]

There are several significant differences between the price and value components listed in Official Comment 3 and negative equity financing. The first is that some of the items identified by courts as transaction costs rather than price components, such as taxes, duties, and freight and storage charges,[60] are in fact components of the retail price of goods and as such are expenses incurred by all retail buyers, whether they finance their purchase of the goods or not.

---

53. *See Price*, 562 F.3d at 627 ("[M]any persons who purchase new vehicles . . . trade in old vehicles with negative equity, so they need to extinguish that negative equity to complete the transaction.").

54. *Ford v. Ford Motor Credit Corp.* (*In re Ford*), 574 F.3d 1279, 1285 (10th Cir. 2009).

55. *Price*, 562 F.3d at 627.

56. *In re Howard*, 597 F.3d 852, 857 (7th Cir. 2010).

57. *Ford*, 574 F.3d at 1284–85.

58. *Nuvell Credit Corp. v. Westfall* (*In re Westfall*), 599 F.3d 498, 504 (6th Cir. 2010) (quoting *Johns v. Ford Motor Credit Co.*, 551 N.E.2d 179, 183 (Ohio 1990)).

59. *Id.*

60. *Price*, 562 F.3d at 627.

The second difference is that some of the other components, such as interest, finance charges, attorney's fees and expenses of collection and enforcement, are not elements of price at all. Rather, they are the charges that are included in most financing agreements. When a secured lender forecloses on its collateral, it is entitled to apply the proceeds of sale to its enforcement costs before applying them to the outstanding loan amount.[61] The Tenth Circuit correctly recognized that creditors incur these expenses to realize the value of their security interests.[62] It then characterized these foreclosure expenses as expenses that permit "the creditor to realize the benefit of its bargain,"[63] in order to analogize such expenses to amounts paid to discharge negative equity, which, because they clear the title of the trade-in vehicle, also allow the creditor to realize the benefit of its bargain.[64] The expenses are not analogous, however. Every foreclosing secured creditor must spend money to reduce its collateral to cash. The bargain that foreclosure allows a secured creditor to realize is the privilege of applying the value of the collateral to its debt ahead of all other creditors. That is the essence of a security interest.

On the other hand, the bargain that the negative equity payoff allows the seller to realize is the sale of the car, not the security interest. The payoff of negative equity bears no relationship to the purchase price of the collateral financed and it is unrelated to the lender's collection expenses. Negative equity is most closely related to a debtor's household budget. There are numerous reasons why a consumer may be unable to afford the car of her choice: she may be burdened by high mortgage payments, high credit card debt, or unsatisfied debt secured by her existing car. Negative equity financing enables an individual to overcome a specific impediment—an existing car loan—but that does not make a negative equity payoff any more a part of a car's price than the satisfaction of a credit card loan. Even courts that recognize a negative equity payoff as part of the price of a vehicle acknowledge that they would not allow a credit card payoff to be considered part of the price of a car.[65]

---

61. U.C.C. § 9-615 (2012–13).
62. *Ford*, 574 F.3d at 1285.
63. *Id.*
64. *Id.*
65. *See, e.g.*, *In re Howard*, 597 F.3d 852, 856 (7th Cir. 2010).

2. PURCHASE MONEY INCLUDES NEGATIVE EQUITY FINANCING BECAUSE STATE MOTOR VEHICLE SALES FINANCE LAWS SAY SO

Finding authority for the proposition that the UCC includes negative equity financing in its definition of purchase money requires a broad interpretation of the Official Comments to Article 9. Article 9, however, is not the only state law to which courts have resorted for a definition of purchase-money security interests. Several of the appeals courts used another type of state law, the motor vehicle sales finance law, to interpret Article 9's definition of "price."

Many, if not most, states have motor vehicle sales finance laws. These are consumer protection statutes that mandate disclosure of the components of a vehicle's price.[66] To some appeals courts that hold that a negative equity payoff is part of the value given to allow a buyer to purchase a car, motor vehicle sales finance statutes provide support for the holding that such a payoff is indeed part of the purchase price.[67]

Courts relying on these statutes in their holdings that negative equity financing can be secured by a purchase-money security interest do so by invoking the statutory interpretation canon of *in pari materia.* According to that canon, statutes relating to the same subject matter must be construed together.[68] Courts accepting the *in pari materia* argument reason that because the motor vehicle sales finance acts and Article 9 of the UCC both relate to the installment financing of motor vehicles, they should be read together.[69]

Although motor vehicle sales finance statutes list the components of the purchase price of a vehicle and some include negative equity financing as part of the "cash price" of a car,[70] they have nothing to do

---

66. *See, e.g.*, CAL. CIV. CODE § 2989.2 (West 2012); GA. CODE ANN § 10-1-32 (2009).

67. *Howard,* 597 F.3d at 857; *Ford Motor Credit Co. v. Mierkowski* (*In re Mierkowski*), 580 F.3d 740, 743 (8th Cir. 2009); *Graupner v. Nuvell Credit Corp.* (*In re Graupner*), 537 F.3d 1295, 1299–1301 (11th Cir. 2008); *Reiber v. GMAC, LLC* (*In re Peaslee*), 913 N.E.2d 387, 390 (N.Y. 2009).

68. MIKVA & LANE, *supra* note 51.

69. *Mierkowski*, 580 F.3d at 743; *Graupner*, 537 F.3d at 1299–1301; *Reiber*, 913 N.E.2d at 390. Of the circuit courts discussing the *in pari materia* argument in their opinions, only the Seventh Circuit recognized that perhaps the two types of statutes should not be considered to govern the same subject matter. Although the Seventh Circuit used the Illinois Motor Vehicle Retail Installment Sales Act to show that negative equity is a common element of the purchase price of a car and thus a part of "price" for the purpose of UCC § 9-103, it recognized that the purpose of the price definition under the motor vehicle act was different from its purpose under the UCC. *Howard*, 597 F.3d at 856–57.

70. *See, e.g.*, CAL. CIV. CODE § 2981 (West 2012) (defining "cash price" as including the "prior credit or lease balance on property traded in"); GA. CODE ANN.

with the creation or priority of security interests. If a financier does not comply with the disclosure requirements, the buyer is entitled to money damages.[71] Some of these statutes also impose licensing requirements on companies that finance the purchase of consumer goods.[72] The statutes say nothing about the permissible extent of a security interest, nor do they define "purchase-money security interest."[73]

Motor vehicle sales finance acts are consumer protection statutes that are designed to provide consumers with full disclosure of the charges that make up the purchase price of an automobile.[74] The UCC, on the other hand, was never intended to be, and indeed is not, a consumer protection statute. Whereas motor vehicle installment sales statutes regulate terms of consumer credit agreements, the UCC does not. Although the UCC includes some sections that may appear to be protective of consumers,[75] it expressly yields to consumer protection statutes.[76] In straining to find a state law definition of purchase-money security interest that includes negative equity, courts have linked two sets of state statutes that should have no role in defining the term "purchase-money security interest" for bankruptcy purposes.

3. THE UCC FACILITATES THE EXPANSION OF COMMERCIAL PRACTICES, THEREFORE IT MUST FACILITATE NEGATIVE EQUITY FINANCING

The last justification for including negative equity in the Official Comment 3 laundry list of price components is based on the policies

---

§ 10-1-31(a)(1) (2009) (same definition). If that amount exceeds the value of the property traded in, the statute directs that it be expressed as a negative number in the required disclosures. CAL. CIV. CODE § 2981.

71. § 2983.1 (allowing a buyer to recover three times the finance charge paid in the event of certain violations of the disclosure requirements); GA. CODE ANN. § 10-1-38(c) (allowing an aggrieved buyer to recover double the time price differential).

72. *See, e.g.*, 69 PA. STAT. ANN. § 604 (West 2004).

73. Pennsylvania's statute refers to the UCC for its definition of security interest. *See* § 603 (defining "security interest" as a "security interest as provided by 13 Pa. C.S. Div. 9," which is Pennsylvania's enactment of UCC Article 9).

74. *See Johns v. Ford Motor Credit Co.*, 551 N.E.2d 179, 182 (Ohio 1990) (explaining that the Ohio motor vehicle financing statute has "as one of its objectives, meaningful disclosure to the consumer of credit terms, so as to avoid uninformed use of financing plans"). Statutes requiring robust disclosure in consumer transactions came into existence at roughly the same time as the UCC. *See* Grant Gilmore, *Chattel Security: II*, 57 YALE L.J. 761, 772–73 (1948).

75. *See, e.g.*, U.C.C. § 9-204 (prohibiting after-acquired property clauses covering consumer goods collateral); § 9-614 (imposing additional foreclosure notice requirements in consumer goods transactions).

76. § 9-201(b).

underlying the UCC. To support their position that negative equity financing should be included in the definition of purchase money, some circuits insist that such inclusion is consistent with the overarching UCC policy of facilitating the "continued expansion of commercial practices through custom, usage and agreement of the parties."[77] It is important to remember that the UCC was adopted shortly after World War II. In the post-war era, financing secured by personal property grew by leaps and bounds to accommodate the needs of small and medium-sized businesses.[78] Big businesses could offer traditional types of collateral, such as real estate and industrial equipment, for their loans, but small and medium-sized businesses had no such collateral. Therefore, parties to commercial transactions fashioned new security devices to accommodate the collateral offered by these businesses, such as raw materials and accounts receivable. As a result of their ingenuity, the pre-UCC law of commercial transactions was complex, scattered, and nonuniform.[79]

Finding authority in the UCC for the inclusion of negative equity financing in the definition of purchase money requires skilled mental gymnastics. It is also unnecessary. As I will explain in Part III below, nothing mandates that the UCC be used to define purchase-money security interest for the purpose of the hanging paragraph, and moreover, the reason for the list of included expenses in Official Comment 3 is inapplicable in consumer finance.

B. The Ninth Circuit Stands Alone

The only circuit court of appeals to deny negative equity purchase-money status is the Ninth Circuit. In *Americredit Financial Services, Inc. v. Penrod*,[80] the court, while holding that state law provides the definition of purchase-money security interest for hanging paragraph purposes, rejected both the argument that Official Comment 3 to UCC section 9-103 supports inclusion of negative equity in purchase money, and that the UCC and the motor vehicle sales finance laws must be read *in pari materia*.[81]

---

77. § 1-103; *In re Price*, 562 F.3d 618, 627–28 (4th Cir. 2009); *Reiber v. GMAC, LLC* (*In re Peaslee*), 913 N.E.2d 387, 389 (N.Y. 2009).

78. Grant Gilmore, *The Secured Transactions Article of the Commercial Code*, 16 LAW & CONTEMP. PROBS. 27, 29 (1951).

79. Peter F. Coogan, *Article 9—An Agenda for the Next Decade*, 87 YALE L.J. 1012, 1015–16 (1978) (lauding Article 9 for bringing a "'labyrinthine' mélange of personal property security law under one roof"); Gilmore, *supra* note 78, at 29.

80. 611 F.3d 1158 (9th Cir. 2010).

81. *Id.* at 1162–63.

The Ninth Circuit rejected the Official Comment 3 argument for two reasons. First, it recognized that when a lender agrees to finance, as part of the deal to purchase a new car, the deficiency owing on the buyer's old car, that lender is satisfying an antecedent debt.[82] The UCC recognizes that purchase-money collateral can secure an obligation that is not a purchase-money obligation in section 9-103.[83] In a nonconsumer transaction, the "dual status rule" applies, under which a security interest does not lose its purchase-money status simply because it secures other obligations, rather, the security interest is divided into a purchase-money component and a non-purchase-money component.[84] The bankruptcy court in *Penrod* recognized this rule—the UCC is silent on whether the dual-status rule applies to consumer transactions and leaves it up to the courts to apply either the dual status rule or the less lender-friendly transformation rule, which transforms the entire security interest into a non-purchase-money security interest[85]—and held that AmeriCredit had a purchase-money security interest for the price of the car and a non-purchase-money security interest for the negative equity.[86] As antecedent debt, negative equity is not sufficiently related to the purchase of a car to be included in the laundry list of price components in Official Comment 3 to section 9-103.

The Ninth Circuit was also unmoved by the argument that even if negative equity is not part of the "price" of a vehicle, it is part of the "value given to enable" the purchase of a vehicle. Several circuits relied on this distinction to support their holding that negative equity belongs on the list of price or value components in Official Comment 3 to section 9-103.[87] The Ninth Circuit acknowledged that there is a difference between "price" and "value given to enable," but correctly identified that difference as one that distinguishes between lenders.[88] When a seller finances the purchase of an item, the purchase-money security interest is for the "price" of the item. This recognizes seller financing as the modern equivalent of the conditional sale. When a third

82. *Id.*

83. U.C.C. § 9-103(f) (2012–13).

84. § 9-103(f) cmt. 7.a.

85. § 9-103(h); *see also* Moringiello, *supra* note 8, at 866–68.

86. *Americredit Fin. Servs. Inc. v. Penrod* (*In re Penrod*), 611 F.3d 1158, 1160 (9th Cir. 2010). The Bankruptcy Court opinion in *Penrod* is not reported.

87. *See, e.g.*, *Nuvell Credit Corp. v. Westfall* (*In re Westfall*), 599 F.3d 498, 503 (6th Cir. 2010) (holding that because the dealer "financed the negative equity on the Debtors' trade-in vehicle precisely to allow Debtors to obtain rights to the vehicle," the negative equity payoff qualifies as "value given to enable" the purchase).

88. *Penrod*, 611 F.3d at 1164.

party finances the purchase, the purchase-money security interest is for the "value given to enable" the purchase.[89]

Although the recognition that negative equity financing is the refinancing of antecedent debt formed the basis of the Ninth Circuit's opinion, the court also rejected the *in pari materia* argument. The court acknowledged that the definition of "cash price" in the California Automobile Sales Finance Act (AFSA) included negative equity charges but stressed that AFSA is a disclosure statute. Therefore, negative equity is included in price under that statute so that consumers will know all of the charges for which they are liable. Because the AFSA definition of price serves a different purpose than the definition of price provided in the Official Comments to the UCC, the court declined to apply the *in pari materia* doctrine.[90]

All of the appeals courts faced with the negative equity question assumed that it was a question of state law. Following a perceived *Butner* mandate, all of the appeals courts presumed that the Article 9 definition of purchase-money security interest controlled, a presumption that likely prevented the Supreme Court from resolving the issue. Moreover, the courts' assumption that the UCC provides the definition of purchase-money security interest resulted in an unnecessary and twisted analysis of the UCC. In the next Part, I will explain why the reliance on *Butner* and the resulting use of Article 9 of the UCC to define purchase-money security interest is misplaced.

III. *BUTNER*, *KIMBELL* FOODS, AND THE PROPER ROLE OF STATE LAW IN BANKRUPTCY

Ever since the Supreme Court decided *Butner v. United States*[91] in 1979, courts in bankruptcy cases, notably those interpreting the hanging paragraph, have relied on it repeatedly in using state law to define property rights in a bankruptcy case. The hanging paragraph opinions display two analytical deficiencies. First, they overemphasize *Butner*'s statement that "[p]roperty interests are created and defined by state law"[92] without giving sufficient consideration to the Court's limiting

---

89. *Id.*; *see also* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 23-6, at 1197 (6th ed. 2010).

90. *Penrod*, 611 F.3d at 1163.

91. 440 U.S. 48 (1979).

92. *Id.* at 55. A Lexis search revealed fifty-three cases citing *Butner* in the one year period preceding March 11, 2012. *See, e.g.*, *Marciano v. Fahs* (*In re Marciano*), 459 B.R. 27, 54 (B.A.P. 9th Cir. 2011) (referring to the statement that "[p]roperty interests are created and defined by state law" as the "*Butner* principle"); *In re DiGregorio*, 458 B.R. 436, 442 (Bankr. N.D. Ill. 2011) ("It is well established that state law defines the nature and attributes of property rights."); *Arsenault v. J.P.*

statement that state law governs property rights unless "some federal interest requires a different result."[93] Second, the opinions lack a rigorous analysis of the property rights inherent in a purchase-money security interest.

In this Part, I address both analytical deficiencies. First, I will discuss the difference between property rights that are bankruptcy entry rights and those that are bankruptcy exit rights. I will then explain how an analysis that includes both *Butner* and *United States v. Kimbell Foods, Inc.*[94] provides a clearer view of the propriety of using state law to define property rights in bankruptcy.[95] Next, I will examine the property characteristics of security interests and purchase-money security interests to show that the interpretation of the term "purchase money" should be guided by a *Kimbell Foods* analysis rather than a *Butner* analysis.

A. Bankruptcy Entry Rights and Bankruptcy Exit Rights

Debtors in financial distress have a choice of procedures through which to resolve that distress. Every debtor can choose to allow her obligations to her creditors to be resolved under state debtor-creditor law. The purpose of state creditors' rights laws is to enable each individual creditor to collect an unpaid debt from the debtor.[96] State law includes Article 9 of the UCC, which allows a creditor to obtain payment from collateral granted to it by the debtor.[97] The rights of both the debtor and creditor in the collateral are necessarily defined by state law at the time that the debtor grants a security interest in the collateral,

---

Morgan Chase Bank, N.A. (*In re Arsenault*), 456 B.R. 627, 630 (Bankr. S.D. Ga. 2011) ("The nature of the Debtors' interest in real property is determined by state law."). For one commentator's view that *Butner* does not support the proposition that bankruptcy law should always be neutral towards state law creditor's rights, see David Gray Carlson, *Philosophy in Bankruptcy*, 85 MICH. L. REV. 1341, 1377 n.117 (1987).

93. *Butner*, 440 U.S. at 55.

94. 440 U.S. 715 (1979).

95. Not a single circuit court of appeals cited *Kimbell Foods* in interpreting the hanging paragraph. Only three lower courts did so. *See Americredit Fin. Servs. v. Penrod* (*In re Penrod*), 392 B.R. 835, 844 (B.A.P. 9th Cir. 2008); *In re Whipple*, 417 B.R. 86, 91 (Bankr. C.D. Ill. 2009); *In re Westfall*, 376 B.R. 210, 214–15 (Bankr. N.D. Ohio 2007).

96. Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775, 782–83 (1987). Although state laws include collective remedies such as receiverships, state collective remedies lost their prominence when federal bankruptcy law became permanent in 1898. Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 COLUM. L. REV. 717, 734–35 (1991) (explaining the historical ties between bankruptcy law and nonbankruptcy collection law).

97. U.C.C. § 9-601 (2012–13).

and these rights give the creditor certain benefits, most importantly the right to foreclose, upon nonpayment.[98]

Bankruptcy, on the other hand, is a collective process that a struggling debtor can use to resolve his obligations to all of his creditors. An important feature of bankruptcy is its "creditor versus creditor" orientation, which shifts the focus from the individual creditor's right to payment from the debtor to the distribution of the debtor's assets among creditors.[99] Only bankruptcy law gives the debtor the opportunity to resolve all of his obligations at one time[100] and to receive a discharge of his unpaid debts.[101] To enable the debtor to resolve all of his debts at once, the bankruptcy case must administer all of the debtor's property interests as of the date the case is commenced.[102] Those interests are defined by state law. The process that administers those rights for all of the creditors at one time and in a single forum, however, is defined by the federal law embodied in the Code.

Bankruptcy entry rights, therefore, are the rights that exist at the time when the debtor takes the act of filing for bankruptcy. Until that moment, only state law can define the extent of the debtor's rights in property because until the moment of filing, there is no collective process, only individual transactions between the debtor and her creditors. Therefore, whether a creditor holds a security interest in an asset is a question of state law because that status arises out of a pre-bankruptcy transaction and commercial certainty depends on bankruptcy law's recognition of pre-bankruptcy status.[103] One notable limitation is the trustee's power to avoid preferential transfers,[104] which allows a trustee to upset security interests that are valid and enforceable under state law. The power to avoid preferential transfers is justified by

---

98. The UCC defines "security interest" as an "interest in personal property . . . which secures payment or performance of an obligation." § 1-201(b)(35); *see also* Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021, 2051 (1994) ("It seems clear enough that security interests, under Article 9 and real estate law alike, are interests in property.").

99. Warren, *supra* note 96, at 785–86.

100. The automatic stay allows this by preventing creditors from pursuing their claims against the debtor after a bankruptcy petition is filed. 11 U.S.C. § 362(a) (2006).

101. § 524.

102. Thomas E. Plank, *The* Erie *Doctrine and Bankruptcy*, 79 NOTRE DAME L. REV. 633, 687 (2004).

103. *See In re Whipple*, 417 B.R. 86, 92 (Bankr. C.D. Ill. 2009); *In re Westfall*, 365 B.R. 755, 759–60 n.4 (Bankr. N.D. Ohio 2007); *Tidewater Fin. Co. v. Moffett* (*In re Moffett*), 288 B.R. 721, 731 (Bankr. E.D. Va. 2002).

104. § 547(b).

the strong bankruptcy policy of equality among creditors, none of whom should be able to drain the estate of assets immediately before bankruptcy.[105]

Bankruptcy exit rights are those that are produced by the bankruptcy process. Federal law must govern the procedural aspect of bankruptcy. Only federal law, codified in the Code, can dictate the procedures for commencing a case, filing a claim, and distributing the debtor's property to creditors.[106] Included in bankruptcy's distributive feature, the sole province of federal law, are matters of claim allowance, claim characterization, priority, and discharge. As a result, although the extent of a security interest on bankruptcy entry is a matter of state law, the treatment of the state-defined security interest for the purpose of determining the distribution to creditors under a Chapter 13 plan is a bankruptcy exit right and therefore a question of federal law.[107]

Butner and *Kimbell Foods* can be explained using this entry/exit framework. The *Butner* opinion itself lays the groundwork for such an analysis. Although the opinion does indeed state that "[p]roperty interests are created and defined by state law," the Court qualified this rule by adding that "[u]nless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding."[108] The federal interest in bankruptcy is the bankruptcy procedure itself, which includes the determination of how each state-defined right will be treated in bankruptcy.

B. Butner *and Bankruptcy Entry*

When the entry/exit distinction is explained using the *Butner* facts, the incompleteness of a *Butner*-centered analysis of the hanging paragraph analysis becomes clear. The dispute in *Butner* was over a secured creditor's perfected status, specifically over whether a mortgagee had a perfected security interest in the rents from real property. The mortgagee had perfected its interest in the real property, but had neither separately perfected its interest in the rents nor taken possession of the property before the debtor filed for bankruptcy.

105. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 124 (1986) ("The idea of preference law is part and parcel of the substitution of collective remedies for individual remedies.").

106. *See* Thomas E. Plank, *Bankruptcy and Federalism*, 71 FORDHAM L. REV. 1063, 1068–69 (2002).

107. *See Whipple*, 417 B.R. at 92; *Moffett*, 288 B.R. at 731.

108. *Butner v. United States*, 440 U.S. 48, 55 (1979).

Therefore, the trustee argued that the mortgagee did not have a perfected pre-petition security interest in the rents collected after the bankruptcy petition was filed. Under the governing North Carolina law, such a mortgagee had no rights in the rents if the mortgagor was in possession of the property.[109]

The specific issue in *Butner* was ultimately resolved by the 1994 amendments to the Code.[110] Before those amendments, a mortgage creditor's right to a security interest in post-petition rents varied according to the law of the state in which the real estate was located.[111] The general bankruptcy rule regarding security interests is that a security interest does not extend to property received by the debtor after the bankruptcy petition is filed.[112] Therefore, even if the agreement creating a security interest states that the interest extends to after-acquired property of the debtor, as allowed by Article 9 of the UCC,[113] the resulting floating lien does not continue to operate after a bankruptcy petition is filed. The Code contains an exception to this rule, however: a security interest extends to post-petition proceeds of and profits from pre-petition collateral, so long as that security interest is perfected under state law.[114] Before 1994, this same rule applied to a mortgage creditor's right to post-petition rents from real estate subject to a pre-petition mortgage. The pre-1994 Code directed courts to look to "the security agreement and . . . applicable non-bankruptcy law" to determine whether a mortgage creditor had obtained a perfected security interest in the rents before the bankruptcy petition was filed.[115] In some states, a mortgage creditor was perfected in rents at the moment it recorded its mortgage; in others, a mortgage creditor was not perfected in rents until it took possession of the real estate.[116]

Before Congress resolved the matter, courts struggled with whether a creditor's entitlement to rents in bankruptcy should be determined by state law or by a federal rule of equity. Because the

---

109. *Id.* at 51.

110. *See* 11 U.S.C. § 552(b)(2) (2006) (granting a secured party with a pre-petition security interest in real estate a security interest in the post-petition rents from that real estate).

111. *See In re Fairview-Takoma Ltd. P'shp.*, 206 B.R. 792, 800–01 (Bankr. D. Md. 1997) (explaining the state of the law pre-*Butner* and how the 1994 Amendments overruled the result in the case).

112. 11 U.S.C. § 552(a).

113. U.C.C. § 9-204(a), (b) (2012–13).

114. *See* 11 U.S.C. § 552(b)(1).

115. *In re Fairview-Takoma Ltd. P'shp.*, 206 B.R. at 800–01 (quoting 11 U.S.C. § 552(b)(1) (1984)).

116. 5 COLLIER ON BANKRUPTCY ¶ 552.LH[1][a] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2004).

entitlement to post-petition rents depended on pre-petition perfection, the question involved a quintessential bankruptcy entry right—the status of a perfected secured creditor. If state law governed, creditors' rights would differ from state-to-state, but would be the same in a given state regardless of whether the property owner filed for bankruptcy. On the other hand, if a federal rule of equity governed, all creditors whose borrowers filed for bankruptcy would be treated alike, regardless of the state in which the property was located, but a creditor's treatment within a state would depend on whether or not its borrower filed for bankruptcy.[117]

In holding that the mortgagee's rights were governed by state law, the Court recognized that Congress has the constitutional authority "[t]o establish . . . laws on the subject of bankruptcies throughout the United States,"[118] and acknowledged that, pursuant to this authority, Congress could enact a statute (which it ultimately did)[119] defining the mortgagee's rights to rents in bankruptcy.[120] The Court then noted that in the absence of such a statute, "Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law."[121]

The remainder of the *Butner* holding seems to have escaped the notice of the appeals courts deciding negative equity cases. In *Butner*, the Court qualified its original statement by stating that "[u]nless some federal interest requires a different result," there is no reason for a property right to be defined in one way if a party is in bankruptcy and in another if a party does not file for bankruptcy.[122] The Court supported uniform treatment of rights within a state by state and federal courts because such treatment reduces uncertainty, discourages forum shopping, and "prevent[s] a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.'"[123] The Court therefore recognized that when considering a bankruptcy entry right, uniformity within a state is paramount.

The Court's holding in *Butner* directs the bankruptcy court, in the absence of any compelling federal interest requiring a different result, to use state law to define the rights of a secured creditor at the moment

117. *See Butner v. United States*, 440 U.S. 48, 51–57 (1979).

118. U.S. CONST. art. I, § 8, cl. 4.

119. 11 U.S.C. § 552(b)(2) removes the reference to "applicable nonbankruptcy law" giving the mortgagee a security interest in post-petition rents if its security agreement so provides.

120. *Butner*, 440 U.S. at 54.

121. *Id.*

122. *Id.* at 55.

123. *Id.* (quoting *Lewis v. Mfrs. Nat'l Bank*, 364 U.S. 603, 609 (1961)).

a bankruptcy petition is filed.[124] As a result, the rights of a debtor and her creditors in her assets will be the same at the moment of filing as they were one minute before the bankruptcy petition was filed. The Court in *Butner* dealt with a priority issue: who is entitled to the rents from mortgaged property before foreclosure? The Court in *Butner* held that this priority status must be determined by state law because there was no federal policy strong enough to upset the state law rule. Priority status is simply an entry status, however; it does not dictate the amount that a creditor will be paid in bankruptcy. As a result, the presumption in favor of state law on bankruptcy entry is very strong.

Without stating so explicitly, the Court in *Butner* limited its pronouncement about state law to property rights that can be considered bankruptcy entry rights and laid the groundwork for an entry/exit analysis. First, it stressed that a "bankruptcy court should take whatever steps are necessary to ensure that the mortgagee is afforded in federal bankruptcy court the same protection he would have under state law if no bankruptcy had ensued."[125] This admonition recognizes that because a debtor in distress may resolve its debts under state or federal law, the property rights of each party at the time either of those processes is commenced should not vary based on the type of process chosen. Second, the Court distinguished between a creditor's priority right and its remedy right, recognizing that although a court can indeed prevent a creditor at least temporarily from foreclosing on its security interest, the money value of the security interest must be protected in bankruptcy so that a secured creditor's loss in bankruptcy is no greater than it would be under state law.[126] Although a remedy right is a component of a property right, it is just the type of property right that bankruptcy law can and does alter,[127] because allowing a secured creditor to exercise its remedy rights in bankruptcy would upset bankruptcy's collectivist policies. The remedy right, therefore, is a bankruptcy exit right and federal concerns overcome the presumption that state law defines property rights.

C. Kimbell Foods *and Bankruptcy Exit Rights*

Once a debtor is in bankruptcy, federal interests take over. Congress exercised its constitutional power to "establish . . . uniform

124. *Id.* at 54–55.

125. *Id.* at 56.

126. *Id.* at 56–57. This point is reflected in the Code's provisions governing the automatic stay and adequate protection. 11 U.S.C. §§ 361, 362 (2006).

127. *See infra* notes 174–177 and accompanying text.

Laws on the subject of Bankruptcies throughout the United States"[128] when it enacted the Code and its predecessors, establishing a federal system for adjusting the relationship between a financially distressed debtor and its creditors. That system relies on state law both explicitly and implicitly.[129] Once a debtor is inside that system, his rights and the rights of his creditors can be modified to achieve the collectivist goals of bankruptcy. The appeals courts that rely on *Butner* to use state law to interpret the hanging paragraph fail to distinguish between the role that state law plays at the moment a bankruptcy petition is filed and the role it plays after the bankruptcy process has begun.

The automatic stay provides an example of how bankruptcy law explicitly modifies a bankruptcy entry right with a bankruptcy exit right unique to federal law. Under state law, a secured creditor has a lien on property that allows the creditor to take possession of and sell that property upon the debtor's default and apply the proceeds of that sale to the debt owed.[130] Under *Butner*, the rights of the debtor and creditor in the collateral are defined by state law at the moment the petition is filed, so the creditor's entry status as a secured creditor is defined by reference to the UCC. After that moment, however, the federal policies supporting bankruptcy's collectivist goals take precedence. By removing the right of the creditor to seize and sell the property for at least some period of time after the petition is filed, the Code's automatic stay supports the collective procedure.[131] The collective nature of bankruptcy requires that bankruptcy law override individual remedies.[132] This modification of rights affects the creditor's bankruptcy exit; absent the automatic stay provision, the creditor could exit bankruptcy immediately by exercising its individual remedy.

Sometimes the Code clearly incorporates state law in defining an exit right. The trustee's strong-arm power provides an example of such explicit incorporation. The Code allows a trustee to avoid any transfer by the debtor that would be voidable by a hypothetical judgment lien creditor who came into existence and perfected its lien at the moment the bankruptcy petition was filed.[133] The trustee's right is then explicitly

128. U.S. CONST. art. I, § 8, cl. 4.

129. *See* Plank, *supra* note 106, at 1070–72 (explaining that the Code specifically defers to state and other nonbankruptcy law in some sections, while implicitly incorporating state and other nonbankruptcy law in defining creditors and property of the estate).

130. *See* U.C.C. §§ 9-207, -601 (2012–13).

131. *See* 11 U.S.C. § 362(a).

132. JACKSON, *supra* note 105, at 28.

133. § 544(a)(1).

limited by any "generally applicable law" that allows a secured creditor's perfection to take priority over a prior lien creditor.[134]

In other sections, the Code provides its own definition of exit rights. The priority provisions provide a good example. Although nonbankruptcy law governs the question of whether a debtor owes taxes on bankruptcy entry, the Code specifies which of those taxes are entitled to priority.[135]

Where the Code neither explicitly incorporates state law nor provides its own rule, as is the case with the hanging paragraph, the courts must decide whether to incorporate state law in interpreting its provisions. When the Code is silent, incorporation of state law is not mandatory, and in some cases, it is not appropriate.[136] Shortly after the Court decided *Butner*, it decided *Kimbell Foods*. *Kimbell Foods* is not a bankruptcy case; it is a case that addressed whether state law could be used as a federal rule of decision to interpret statutes governing federal loan programs.[137] It is nevertheless particularly helpful in determining the role of state law in interpreting bankruptcy exit rights. Although the appeals court decisions on the hanging paragraph are rife with citations to *Butner*, not a single one of those decisions refers to *Kimbell Foods*, a case that is far more helpful in determining the applicability of state law in interpreting the Code.[138]

An analysis of the *Kimbell Foods* line of cases leads to a far more nuanced analysis of the proper role of state law as an interpretive tool in bankruptcy. Because *Kimbell Foods* involved the priority of liens arising from federal loan programs, the Court was required to decide first, whether federal or state law governed the controversy, and second, if federal law governed, whether such law should be a national

---

134. § 546(b)(1)(A).

135. *See* § 507(a)(8).

136. *See* Vern Countryman, *The Use of State Law in Bankruptcy Cases (Part I)*, 47 N.Y.U. L. REV. 407, 410 (1972) ("Congress is not required to direct the federal courts to look to state law for the definition of state-created rights asserted in bankruptcy.").

137. *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 718 (1979).

138. The Bankruptcy Appellate Panel in *Penrod* and two bankruptcy courts recognized the applicability of *Kimbell Foods* to the negative equity question. *See Americredit Fin. Servs., Inc. v. Penrod (In re Penrod)*, 392 B.R. 835, 853–55 (B.A.P. 9th Cir. 2008) (citing *Kimbell Foods* to support its conclusion that importing any Article 9 interpretation of the term purchase money security interest into the hanging paragraph would result in unacceptable nonuniformity); *In re Whipple*, 417 B.R. 86, 93 n.8 (Bankr. C.D. Ill. 2009) (quoting *Kimbell Foods* for the proposition that "federal courts are to 'fill the interstices of federal legislation according to their own standards'"); *In re Westfall*, 376 B.R. 210, 214–17 (Bankr. N.D. Ohio 2007) (engaging in an extended analysis of *Kimbell Foods* and concluding that application of the *Kimbell Foods* standard for applying state law is "a muddle on the current facts").

priority rule fashioned by the Court or whether it should incorporate state law.[139]

Relying on its earlier decision in *Clearfield Trust Co. v. United States*,[140] the Court held that because the Small Business Administration and the Federal Housing Administration operated their loan programs under acts of Congress passed in the exercise of a "constitutional function or power," the rights of those agencies should come from federal law.[141] The governing federal statutes, however, did not establish priorities between federal and private liens; therefore, the Court was required to determine the content of the federal law.[142] To do so, the Court had a choice: develop a uniform federal priority rule or incorporate state law as the federal rule.[143]

In *Kimbell Foods*, the Court recognized that not all federal programs require uniform federal rules. In determining whether to incorporate state law as the federal rule, the Court considered "the extent to which application of a federal rule would disrupt commercial relationships predicated on state law."[144] In that case, the federal programs at issue were loan programs under which the agencies were voluntary creditors who evaluated the borrowers' credit in the same way that a private creditor would.[145] Therefore, the Court held that state commercial law should provide the priority rule for the federal loan programs.[146]

Although *Kimbell Foods* gives great deference to state commercial law, such deference was context specific and should not apply to the hanging paragraph. The Court in *Kimbell Foods* acknowledged that parties in business transactions rely on state commercial law rules to evaluate the risks involved in their transactions.[147] Therefore, a private creditor who relies on the UCC priority system to insure that its lien has first priority in a debtor's assets should not have its expectations destroyed by a federal rule that would give a subsequent government creditor priority in the same assets.[148] In a later case, *Kamen v. Kemper Financial Services, Inc.*,[149] the Court characterized this deference to

139. *Kimbell Foods*, 440 U.S. at 718.
140. 318 U.S. 363 (1943).
141. *Kimbell Foods,* 440 U.S. at 726.
142. *Id.* at 727.
143. *Id.* at 727–28.
144. *Id.* at 728–29.
145. *Id.* at 736–37.
146. *Id.* at 718.
147. *Id.* at 739.
148. *Id.*
149. 500 U.S. 90 (1991).

state law as a presumption, one that is "particularly strong in areas in which private parties have entered into legal relationships with the expectation that their rights and obligations would be governed by state law standards."[150]

Several courts in bankruptcy cases have applied a *Kimbell Foods* analysis to determine whether to use state law to interpret the Code. This is the right approach; like the loan programs at issue in *Kimbell Foods*, bankruptcy law was passed by Congress in its exercise of a constitutional power.[151] In doing so, these courts have engaged in a three-step analysis, considering: first, whether uniformity is necessary; second, whether application of state law would thwart a federal policy; and third, the extent to which a federal rule would disrupt commercial relationships premised on state law.[152] In applying this test, several courts ruled that a uniform federal rule should determine whether a constructive trust exists for the purpose of determining the extent to which a right in property becomes property of the bankruptcy estate,[153] while another held that state law as codified in the UCC should define the term "proceeds" for the purpose of determining the post-petition effect of a security interest.[154]

An analysis of both *Butner* and *Kimbell Foods* clarifies the acceptable role of the UCC in defining Code terms. When the two cases are read together, it becomes clear that *Butner* establishes a "bankruptcy entry" rule and *Kimbell Foods* determines the "bankruptcy exit" rule. By stating that the Code must respect state law property rights unless a federal interest dictates otherwise, *Butner* preserves state law as the source of bankruptcy entry rights. Bankruptcy, however, is a collective proceeding that is governed by federal law after entry. As a result, a federal rule should govern exit rights. Under *Kimbell Foods*, a court can, but need not, incorporate state law in its federal rule of decision.

Therefore, when determining the appropriate extent to which to incorporate state law in Code interpretation, a court should first determine whether the undefined term provides a bankruptcy entry right

150. *Id.* at 98.

151. *See* Plank, *supra* note 106, at 1064 .

152. *Dzikowski v. N. Trust Bank of Fla., N.A.* (*In re Prudential of Florida Leasing, Inc.*), 478 F.3d 1291, 1298 (11th Cir. 2007); *Official Comm. of Unsecured Creditors of the Columbia Gas Transmission Corp. v. Columbia Gas Sys. Inc.* (*In re Columbia Gas Sys. Inc.*), 997 F.2d 1039, 1055 (3d Cir. 1993); *EBS Pension L.L.C. v. Edison Bros. Stores, Inc.* (*In re Edison Bros., Inc.*), 243 B.R. 231, 235–36 (Bankr. D. Del. 2000).

153. *Columbia Gas*, 997 F.2d at 1055–58; *Edison Bros.*, 243 B.R. at 235–36.

154. *In re Las Vegas Monorail Co.*, 429 B.R. 317, 342–43 (Bankr. D. Nev. 2010).

or a bankruptcy exit right. If the court determines that the undefined term grants an exit right, the court must apply a federal rule, but must then decide whether it is appropriate to use state law as that federal rule, using the three-part test developed by the bankruptcy courts that have relied on *Kimbell Foods*.

D. Does Purchase-Money Status Define an Entry Right or an Exit Right?

It is easy to assume, as did the appeals courts that considered the hanging paragraph, that the term "purchase-money security interest" describes a bankruptcy entry right. It is well established that a creditor's secured status depends on nonbankruptcy law.[155] The appeals courts assumed that purchase-money status confers a property right that is relevant under nonbankruptcy law. As the Supreme Court cautioned in *United States v. Craft*,[156] however, "[i]n looking to state law, we must be careful to consider the substance of the rights state law provides, not merely the labels the State gives these rights or the conclusions it draws from them."[157] As I will explain in this Section, when collateral for a loan consists of consumer goods (such as an automobile subject to the hanging paragraph), there is no difference between purchase-money priority and ordinary secured creditor priority. The designation of a security interest as purchase money, therefore, is relevant only to the exit right of distribution provided by the hanging paragraph.

To determine whether purchase-money status confers a state law property right that must be respected in bankruptcy, it is first necessary to identify the property rights embodied in every security interest. The property rights included in security interests fall into two categories: remedy rights and priority rights. The remedy, or *in rem*, component of a security interest allows a secured party to keep its lien until its loan is paid in full and seize and sell property if the debtor fails to pay.[158] The

155. *See* TABB, *supra* note 13, § 7.27, at 737 ("[B]ankruptcy law does not create rights of security; it only enforces rights that arise outside of bankruptcy under applicable non-bankruptcy law.").

156. *United States v. Craft*, 535 U.S. 274 (2002).

157. *Id.* at 279. The question in *Craft* was whether a federal tax lien could attach to property held by a couple as tenants by the entirety. *Id.*

158. *See Nobelman v. Am. Sav. Bank*, 508 U.S. 324, 329 (1993) (describing the rights of a secured creditor); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97, 112 (1984); Theodore Eisenberg, *The Undersecured Creditor in Reorganizations and the Nature of Security*, 38 VAND. L. REV. 931, 950–51 (1985).

priority component, on the other hand, entitles the secured creditor to be paid ahead of other creditors to the extent of the value of its collateral.[159]

Both of these components of security are codified in the UCC. All security agreements are generally effective between the parties and against third parties.[160] All secured creditors are given the remedies provided in Part 6 of Article 9, which allows a creditor to seize and sell property and apply the proceeds to its debt before any subordinate secured creditors are paid.[161] The UCC contains priority rules, which generally provide that the first creditor to give public notice of (or "perfect" in UCC terms) its security interest has first priority in the collateral.[162]

Purchase-money secured creditors are entitled to special priority rights under the UCC. A purchase-money security interest in goods has priority over earlier-perfected security interests in the same goods if the purchase-money security interest is perfected when the debtor receives the goods or within twenty days thereafter.[163] The prior security interest would necessarily be a security interest that covered both property that the debtor owned at the time of granting the prior interest, as well as after-acquired property. The after-acquired property clause, specifically allowed by the UCC,[164] triggers the priority contest. If a security interest could not reach after-acquired property, there would be no need for special priority for purchase-money security interests.

When a creditor has a purchase-money security interest in a consumer good, such as an automobile subject to the hanging paragraph, this special priority is unnecessary. After-acquired property clauses are not effective when the collateral is consumer goods.[165] As a result, when the collateral is a car "acquired for the personal use of the debtor" as it must be for the hanging paragraph to apply,[166] there will be no priority contest.[167] Therefore, the priority rights of secured creditors and purchase-money secured creditors are identical when their collateral consists of consumer goods.

---

159. Eisenberg, *supra* note 158, at 952.

160. U.C.C. § 9-201(a) (2012–13).

161. §§ 9-609, -610, -615.

162. *See* § 9-322(a)(1) ("Conflicting perfected security interests . . . rank according to priority in time of filing or perfection.").

163. § 9-324(a).

164. § 9-204(a).

165. § 9-204(b)(1).

166. 11 U.S.C. § 1325(a)(*) (2006).

167. The UCC defines consumer goods as "goods that are used or bought for use primarily for personal, family, or household purposes." U.C.C. § 9-102(a)(23).

Purchase-money status in consumer goods outside of bankruptcy matters for one reason: the secured party need not give any public notice of its security interest. Such security interests are automatically perfected upon attachment.[168] The original drafters' decision to exempt purchase-money security interests in consumer goods from public notice requirements was a compromise position in the 1940s that appears not to have been reconsidered since.[169] Some, particularly Grant Gilmore, have proposed that all security interests in consumer goods—purchase money and non-purchase-money—be exempt from the filing requirement.[170] Exempting all consumer goods transactions might have been justified because of the nature of the competing parties: buyers of used consumer goods, who do not check records, and unsecured creditors, who rely on the consumer's ability to pay rather than on the public records of security interests.[171]

This perfection benefit, however, is unavailable to creditors who take security interests in automobiles. In all states, automobiles are subject to certificate of title statutes, which require that a lien on a car be perfected by noting that lien on the certificate of title.[172] The UCC defers to these other state laws for perfection purposes, therefore, even purchase-money creditors must give public notice of their security interests.[173]

The secured creditor's priority right is the state-defined entry right that the Code respects. The Code reflects a policy that a secured creditor in bankruptcy "is entitled to the *value* of its property rights, as measured by the value of its collateral, and not to the *in rem* rights themselves."[174] This view is reflected in the Code's provisions governing the automatic stay,[175] turnover of collateral by creditors,[176] and use or sale of the collateral by the trustee,[177] all of which prevent

---

168. § 9-309(1).

169. *See generally* J. Francis Ireton, *The Proposed Commercial Code: A New Deal in Chattel Security*, 43 ILL. L. REV. 794, 801 (1949) (describing the original UCC drafting process).

170. Gilmore, *supra* note 74, at 784–85.

171. *Id.*

172. *See Certificate of Title Act Summary*, UNIFORM L. COMMISSION, http://uniformlaws.org/ActSummary.aspx?title=Certificate%20of%20Title%20Act (last visited Sept. 22, 2012).

173. *See* §§ 9-309(1), -311(b) (excepting collateral covered by a certificate of title statute from the automatic perfection rule).

174. Margaret Howard, *Secured Claims in Bankruptcy: An Essay on Missing the Point*, 23 CAP. U. L. REV. 313, 313 (1994) (emphasis in original); *see also* Eisenberg, *supra* note 158, at 972–73.

175. *See* 11 U.S.C. § 362 (2006).

176. *See* § 542.

177. *See* § 363.

the secured creditor from possessing and using the item of collateral itself.

Purchase-money status in an automobile subject to the hanging paragraph, therefore, is only relevant in bankruptcy. Because purchase-money status under state law does not confer a special priority right to a secured party when the collateral is an automobile acquired for the debtor's personal purposes, that status cannot be a bankruptcy entry right. Such status is relevant only to the bankruptcy distribution prescribed by the hanging paragraph. Only a 910 lender with a purchase-money security interest is entitled to full payment; all other undersecured lenders are subject to bifurcation and cram down. Therefore, purchase-money status denotes a bankruptcy exit right. Because purchase-money status grants bankruptcy exit right, under *Kimbell Foods,* a court must define purchase-money status with reference to federal law. In the next Part, I will discuss whether the Code and its legislative history provide any guidance to the courts in fashioning a federal rule to define purchase-money security interest for hanging paragraph purposes.

IV. DOES THE REMOVAL OF § 506 REQUIRE UNIFORMITY OR TOLERATE THE LACK OF UNIFORMITY?

Once the party's entry rights in assets are determined according to state law, bankruptcy law determines their exit rights through its rules regarding distribution to creditors. Because § 506 is the starting point for determining these exit rights, the statement that "§ 506 does not apply" to 910 loans does not direct the court to use state law to fill the gap. Section 506, in providing rules for the valuation of collateral[178] and the bifurcation of claims,[179] is critical to the distribution determination. As such it is an important part of the federal policy that underlies the Code.

By stating that § 506 "shall not apply" to 910 claims, the hanging paragraph invalidates a specific federal rule that furnishes the starting point for distribution. The invalidation of this rule does not mandate its replacement with state law, rather, it requires the court to fashion a federal rule, which may or may not incorporate state law.

As explained above, courts applying *Kimbell Foods* in bankruptcy cases have applied a three-part test for determining whether state law should provide the federal rule when the Code is silent as to the appropriate rule. Under that test, a court should consider whether

178. § 506 (a)(2).
179. § 506 (a)(1).

uniformity is necessary and whether application of state law would thwart a federal policy.[180] To analyze these questions, courts have looked both to the language of the Code[181] and its legislative history.[182] In this Part, I will discuss both the language of the hanging paragraph and its legislative history and conclude that both support the conclusion that Congress intended that 910 loans be treated uniformly nationwide.

A. Clues from the Statutory Language

The Bankruptcy Act of 1898 ("Act") contained no section comparable to § 506. The Act spoke of "secured creditors," rather than "secured claims."[183] This classification rendered the Act "ambiguous and vague" on whether an undersecured creditor was to be treated as "a secured creditor, or as a partially secured and partially unsecured creditor."[184] According to the legislative history of the Code, this ambiguity was particularly pronounced in Chapter XIII, the predecessor to today's Chapter 13.[185] Courts applying the Act were split on how to treat undersecured creditors in bankruptcy, causing debtors to err on the side of overprotecting undersecured creditors when formulating their repayment plans.[186]

The Code shifts the focus from the creditor's status as a secured creditor to the creditor's status as a holder of a secured claim. It does this through § 506(a), which classifies the stakeholders in the bankruptcy estate in terms of claims, not creditors.[187] By making explicit the undersecured creditor's dual status as a secured claimholder and an unsecured claimholder, the Code is considered to be superior to

---

180. *See supra* notes 151–154 and accompanying text.

181. *E.g.*, *Dzikowski v. N. Trust Bank of Fla., N.A.* (*In re Prudential of Fla. Leasing, Inc.*), 478 F.3d 1291, 1299 (11th Cir. 2007) (holding that a uniform federal rule was appropriate because § 550(d) of the Code creates a single satisfaction rule that applies only to claims that arise under federal law).

182. *E.g.*, *EBS Pension, L.L.C. v. Edison Bros. Stores, Inc.* (*In re Edison Bros., Inc.*), 243 B.R. 231, 236 (Bankr. D. Del. 2000) (looking to the legislative history of § 541(d) in holding that federal common law defines a constructive trust for bankruptcy purposes).

183. *See Enewally v. Wash. Mut. Bank* (*In re Enewally*), 368 F.3d 1165, 1168 (9th Cir. 2004).

184. H.R. REP. NO. 95-595, at 180–81 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6141.

185. *Id.*

186. *Id.* at 6142.

187. *See* COLLIER, *supra* note 116, at ¶ 506-8.

the Act in balancing the interests of secured and unsecured creditors, thus facilitating repayment plans.[188]

This classification provides the starting point for determining the undersecured creditor's rights upon bankruptcy exit. By giving the undersecured creditor a secured claim equal to the value of its collateral, it confirms that secured creditors receive in bankruptcy the same priority rights in their collateral that they enjoy outside of bankruptcy. This rule that secured creditors can enforce their rights against designated property (their collateral) before unsecured creditors has been described as "one of the most basic and important [rules] in our entire commercial system."[189]

Although § 506(a) mirrors nonbankruptcy law in bifurcating an undersecured creditor's claim into a secured claim for the value of the collateral and an unsecured claim for the deficiency, it does not incorporate state law, either explicitly or implicitly. Rather, in defining claims for bankruptcy exit purposes, it imposes a bankruptcy rule of bifurcation. When viewed in the entry/exit framework, § 506 provides rules regarding rights on bankruptcy exit. Its bifurcation rule, a federal rule, reflects an undersecured creditor's state law entitlement.[190]

Congressional intent to define claims in bankruptcy law rather than state law terms is explicit in other subsections of § 506. An undersecured creditor's secured claim is equal to the value of the collateral. Valuation is one of bankruptcy's most critical issues. Collateral value determines whether the creditor is entitled to relief from the automatic stay,[191] the amount of adequate protection it may request,[192] and perhaps most importantly, the amount of its bankruptcy distribution.[193]

Outside of bankruptcy, that value is determined by the foreclosure sale.[194] In bankruptcy, however, the sale may be delayed, or, if the debtor files for Chapter 13, it may never happen. Because valuation is related to distribution, it is defined by federal law, both in the statute itself and by case law. The Code generally directs courts to define

---

188. *See* Mary Josephine Newborn, *Undersecured Creditors in Bankruptcy:* Dewsnup, Nobelman*, and the Decline of Priority*, 25 ARIZ. ST. L.J. 547, 570 (1993).

189. TABB, *supra* note 13, § 7.27, at 735.

190. *See Americredit Fin. Servs, Inc. v. Penrod* (*In re Penrod*), 392 B.R. 835, 840 (B.A.P. 9th Cir. 2008).

191. 11 U.S.C. § 362(d) (2006) (allowing a creditor to obtain relief from the stay if its interest in property is not adequately protected or if the debtor has no equity in the property and the property is not necessary for an effective reorganization).

192. § 361 (providing various methods of protecting a creditor from a decrease in the value of the debtor's property in which the creditor has an interest).

193. §§ 1129(b)(2), 1325(a)(5).

194. U.C.C. § 9-615 (2012–13).

value "in light of the purpose of the valuation and of the proposed disposition or use of such property."[195] Before BAPCPA, that was the rule in all types of bankruptcy cases. Following the Code's mandate, courts consider bankruptcy policy in determining the value of collateral.[196]

In consumer bankruptcy cases, the legislative intent to define value in bankruptcy terms is even clearer. When the debtor is an individual in Chapter 7 or 13, the Code defines value as "replacement value."[197] Judges have even less discretion in determining value when the property is used for personal, family, or household purposes; in that case, value means "the price a retail merchant would charge for property of that kind considering the age and condition of the property at the time value is determined."[198] This specificity is an example of legislative intent to express bankruptcy law's authority in the area of claim classification.[199]

By stating that § 506 does not apply to 910 loans, the Code explicitly states only that its specific uniform mandates regarding classification and valuation of secured claims shall not apply to creditors holding purchase-money security interests in cars purchased within 910 days of the debtor's bankruptcy filing. Although Congress could have stated specifically that state law would apply to such claims, it did not. State law is not a general gap-filler in bankruptcy; rather, it provides the definition of the bankruptcy entry rights of both the debtor and the creditor.[200] In several sections, the Code clearly expresses the legislative intent that nonbankruptcy law be used.[201] The hanging paragraph is not one of those sections.

Section 506 clearly requires that claims be defined uniformly nationwide for the purpose of bankruptcy distribution. Its removal by the hanging paragraph, however, does not dictate the converse. The hanging paragraph does not incorporate nonbankruptcy law. Nor does it give any specific guidance regarding the treatment of 910 loans.

---

195. 11 U.S.C. § 506(a).

196. *See, e.g.*, *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 955–56 (1997) (adopting a replacement value standard in Chapter 13 because it best reflected the Code's policies).

197. § 506(a)(2).

198. *Id.*

199. *In re Pruitt*, 401 B.R. 546, 559 (Bankr. D. Conn. 2009).

200. *See* Austin, *supra* note 6, at 1162 ("State law is clearly the starting point for property rights, but there is no basis to conclude that such rights are inviolate in bankruptcy.").

201. *See, e.g.*, § 522(b)(3) (allowing a debtor to exempt property that is exempt under "State or local law"); § 546(b) (subjecting the trustee's rights to any "generally applicable law" that provides second-in-time, first-in-right priority).

Therefore, the hanging paragraph indicates no intent whatsoever regarding uniformity.

The purpose of BAPCPA sheds a bit more light on whether a uniform federal rule is necessary to interpret the hanging paragraph. By protecting a "creditor with a purchase money security interest," rather than the holder of a purchase-money secured claim, the hanging paragraph could be interpreted to return the treatment of undersecured 910 loans back to pre-Code practice. Such an interpretation would reintroduce the uncertainty that prevailed before the Bankruptcy Code was enacted.[202] Uncertainty and judicial discretion were certainly not goals of BAPCPA; the most prominent and controversial element of BAPCPA was the "means test," which is designed to remove judicial discretion in the determination of matters such as an individual's eligibility for Chapter 7 and the amount an individual debtor must pay in a Chapter 13 plan.[203] Although the language of § 506 clearly indicates a congressional intent that the section be applied uniformly, the language of the hanging paragraph is silent. Therefore, it is necessary to consider the legislative history of the provision.

B. Clues from the Legislative History

The legislative history of the hanging paragraph indicates the congressional desire for uniformity in the treatment of 910 loans. In order to appreciate the legislative development of the hanging paragraph, it is important to consider what happens to an undersecured car loan in bankruptcy. Before BAPCPA was enacted, all individual debtors, as long as they met the eligibility requirements for Chapter 13,[204] had a choice of bankruptcy chapters. They could either liquidate their nonexempt assets under Chapter 7, or they could keep all of their

---

202. *See generally* Vern Countryman, *Partially Secured Creditors under Chapter XIII*, 50 AM. BANKR. L.J. 270–74 (1976) (describing the nonuniform treatment of undersecured creditors under the Bankruptcy Act).

203. *See* Robert M. Lawless et al., *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, 82 AM. BANKR. L.J. 349, 356 (2008) (explaining that the proponents of BAPCPA wanted to replace the substantial abuse test for determining eligibility for Chapter 7 relief because it called for "ample judicial discretion"); Charles J. Tabb & Jillian K. McClelland, *Living with the Means Test*, 31 S. ILL. U. L.J. 463, 466 (2007) (explaining that the consumer credit industry was "disenchanted" with the pre-BAPCPA substantial abuse standard for dismissal of a Chapter 7 case, in part because it allowed "extensive judicial discretion").

204. The Code requires that a Chapter 13 debtor have a regular income and have debts no greater than set debt limit. 11 U.S.C. § 109(e).

property and pay the claims against them according to a Chapter 13 plan.[205]

If an individual who files for Chapter 7 wants to keep a car subject to a security interest after bankruptcy, the Code gives her two ways to do so. She can either redeem the property from the security interest or reaffirm the debt. In order to redeem the property, she must pay the full amount of the secured claim to the creditor in a lump sum.[206] A more appealing option for many debtors is reaffirmation, which allows the debtor to pay the secured creditor in installments.[207] The creditor must agree to a reaffirmation, and in most cases, the creditor will only agree to a reaffirmation if the debtor pays its claim, including any deficiency, in full.[208] Some courts also permitted a third option, commonly known as ride-through. Under that option, if a debtor continued to make her scheduled loan payments, even without reaffirming the debt, the court would not allow the creditor to take possession of the vehicle.[209]

Debtors in Chapter 13 keep their property, and until BAPCPA, all undersecured automobile loans could be crammed down. Cram down guarantees an undersecured creditor only the present value of its secured claim, paid over the plan period.[210] As a result, an automobile lender that was owed $10,000 on a loan for a car worth $7500 was entitled to receive the present value of $7500 over the course of the Chapter 13 plan and its *pro rata* share of its $2500 deficiency claim.[211] Because cars depreciate rapidly in their early years, a secured loan for a new car becomes undersecured quickly if the buyer pays only a small down payment. Therefore, cram down is most painful for the lender in the early years of a new car loan.[212]

Bifurcation is not the only reason that automobile lenders preferred their Chapter 7 treatment. In Chapter 13, the interest rate necessary to provide present value is one imposed by the court, rather than the

205. *See* Lawless, *supra* note 203, at 356–57 (explaining chapter choice pre- and post-BAPCPA).

206. § 722.

207. § 524(c).

208. *See* Whitford, *supra* note 19, at 144–45.

209. Braucher, *supra* note 1, at 462 (explaining and discussing BAPCPA's purported elimination of ride-through).

210. § 1325(a).

211. *See* § 1325(a)(5).

212. *See* Whitford, *supra* note 19, at 178 (describing testimony given to the House Judiciary Committee).

interest rate in the original loan agreement.[213] In a reaffirmation, on the other hand, a creditor could demand its original contract rate of interest. The possibility of bifurcation and interest rate reduction caused car lenders to prefer Chapter 7 over Chapter 13.[214]

BAPCPA threatened to force more debtors into Chapter 13. During the debates preceding BAPCPA, one allegation loomed large: the allegation that too many debtors with the ability to pay a portion of their debts were discharging their debts in Chapter 7. That claim led to the means test, which was designed to push more of these high-income debtors into Chapter 13.[215] The specter that the means test would in fact push more debtors into Chapter 13 was unattractive to the automobile lenders because they received lower payments in Chapter 13.

The drafting history of BAPCPA demonstrates that automobile lenders were concerned about depreciation, but nowhere in any legislative materials or commentary is negative equity financing mentioned. The legislation that became BAPCPA was debated for eight years, and over that eight-year period, there were several different proposals for the treatment of automobile loans. Under one, the prohibition on cram down was placed in § 506 so that a debtor would be required to pay the full outstanding amount of the loan even in a Chapter 7 redemption.[216] Other proposals that failed to pass included a cram down prohibition applicable to all personal property security interests, including non-purchase-money security interests.[217]

One predecessor bill to BAPCPA would have provided a federal rule for determining the value of an undersecured car lender's secured claim. That bill explicitly defined the extent of a security interest in an automobile by stating that the "allowed secured claim shall be not less than the unpaid principal balance of the purchase price of the personal property acquired and unpaid interest and charges at the contract rate."[218] The bill that passed, stating only that § 506 does not apply to

---

213. *See generally Till v. SCS Credit Corp.*, 541 U.S. 465, 478–80 (2004) (holding that the appropriate cram down interest rate should be the prime rate plus an appropriate risk adjustment).

214. Whitford, *supra* note 19, at 144.

215. *See* Lawless, *supra* note 203, at 356 (explaining the purpose of the means test).

216. Under 11 U.S.C. § 722 (2006), in order to redeem personal property collateral from a security interest, the debtor must pay the allowed secured claim in full. Had the limitation on cram down remained in § 506, a debtor seeking to redeem property from a security interest would have been required to pay the full outstanding amount of the loan. *See* Whitford, *supra* note 19, at 179 (describing the first conference report on the bankruptcy reform legislation).

217. Whitford, *supra* note 19, at 180–81.

218. H.R. 3150, 105th Cong. § 128 (1998) (as introduced in House of Representatives, February 3, 1998).

910 loans, sets forth no such explicit federal rule. The House Report accompanying the successful bill is not helpful in guiding courts to the appropriate rule to apply in that it explains only that the hanging paragraph is "a prohibition against bifurcating a secured debt."[219]

The hanging paragraph, in dictating that § 506 does not apply to 910 loans, negates only § 506. In its place, however, is a void—the hanging paragraph does not provide an alternative method of determining the extent of the 910 creditor's secured claim. The legislative history of the hanging paragraph indicates only that car lenders wanted protection against depreciation of their collateral. This would indicate a preference for uniformity; all 910 lenders, whether their debtors are located in New York or California, would want this protection. In the next Part, I will demonstrate that state law has little to say about purchase-money security interests in consumer goods, and the little that it does say is irrelevant outside of bankruptcy. Because of this, and because purchase-money priority in consumer goods under Article 9 was at best an afterthought, state law does not provide the appropriate federal rule under the *Kimbell Foods* test.

V. Why the Bankruptcy Code Should not Incorporate the UCC Definition of Purchase Money

The hanging paragraph and its legislative history indicate that Congress intended that all 910 lenders be treated uniformly. The need for uniformity, however, does not necessarily end the *Kimbell Foods* analysis, especially when the state law is found in Article 9 of the UCC, a law that is substantially uniform nationally. Under *Kimbell Foods*, a court must also determine whether state law would thwart a federal policy and whether a uniform federal rule would disrupt commercial relationships based on state law. In this Part, I discuss the history and purpose of purchase-money priority under the UCC and its irrelevance to consumer transactions. Because purchase-money status under state law is irrelevant to 910 lenders, a federal rule would not disrupt commercial relationships based on the UCC. Notwithstanding its irrelevance, application of state law has the potential to thwart a federal policy; the current split among circuits on the negative equity question gives the hanging paragraph a different effect in California than it has in New York, thus defeating the uniformity that Congress may have intended.

219. H.R. Rep. No. 109-31, pt. 1, at 17 (2005).

A. The History and Purpose of Purchase-Money Priority

Article 9 confers several advantages on the purchase-money secured creditor. The most important is second-in-time, first-in-right priority. Under Article 9, when two creditors claim an interest in the same collateral, the first to give public notice of its interest has a first claim on the foreclosure proceeds of the collateral.[220] When one of those creditors is a purchase-money creditor, however, the purchase-money creditor is entitled to first priority in the collateral it financed if it gives notice of its security interest within twenty days after the debtor receives the property.[221] It is therefore said that purchase-money creditors enjoy an exalted status under Article 9.[222]

The exalted status of purchase-money secured creditors would appear to give purchase-money status significance under state law that should be recognized in bankruptcy. As I explained earlier, however, purchase-money status does not convey a special priority benefit when the collateral is consumer goods.[223] In this Section, I will explain the history of purchase-money priority in order to demonstrate that the list of price and value components in Official Comment 3 to section 9-103 is relevant only when the purchase-money creditor claims priority over a first-in-time creditor.

Purchase-money priority existed before it was codified in Article 9. Courts developed purchase-money status in the mid-1800s during the railroad construction boom.[224] The concept of purchase-money priority developed in tandem with that of allowing a secured party to claim an interest in after-acquired property. Courts recognized after-acquired property clauses as necessary to facilitate railroad construction financing so that the railroads would not be required to borrow relatively small amounts of money as each section of the railroad was completed.[225] Before judicial recognition of these clauses, the lender

---

220. U.C.C. § 9-322(a)(1) (2012–13).

221. § 9-324(a). A different rule applies to purchase money security interests in inventory. § 9-326(b).

222. In a 1995 article, Professor James J. White colorfully described the perfected secured creditor as "the King" and purchase money secured creditors as "the most direct challengers of the King [who] enjoy most the best recognized priority of all [others who claim an interest in collateral]." James J. White, *Reframing Article 9 Priorities in Light of Old Ignorance and New Filing Rules*, 79 MINN. L. REV. 529, 560 (1995).

223. *See supra* notes 165–167 and accompanying text.

224. Russell A. Hakes, *According Purchase Money Status Proper Priority*, 72 OR. L. REV. 323, 330–33 (1993).

225. *Id.* at 333–34.

was required to separately perfect its interest (by filing a supplemental mortgage, for example), each time that it acquired a new asset.[226]

Judicial recognition of after-acquired property clauses allowed lenders to obtain floating liens encumbering both the collateral owned by the debtor at the time the security agreement was signed and collateral later acquired by the debtor. The existence of these clauses established an important priority conflict: that between the floating lienor and the entities that financed the acquisition of the after-acquired property. Without the ability of a secured creditor to encumber property that the debtor did not yet own on the date it granted its security interest, purchase-money priority would be unnecessary.[227]

Purchase-money priority could be justified through the application of the derivative title rule. Under this rule, a transferee obtains all of its rights in property from its transferor and cannot obtain greater rights than its transferor.[228] Applied to financing, an owner/debtor acquired property subject to the rights of its seller, who, to secure the purchase price, retained title to the goods. Because the debtor acquired the goods subject to this superior right of the seller, the original floating lien financier also took its (security) interest subject to the seller's superior interest.[229]

Article 9 of the UCC incorporated the pre-UCC floating lien by permitting the debtor to grant a security interest in almost everything it owns, whether the debtor owns that property at the time that the interest is granted or acquires the property sometime after the interest is granted.[230] Without purchase-money priority, a floating lien creditor could have excessive control over a debtor, who, without the floating lien creditor's permission, would not be able to grant priority to purchase-money creditors.[231]

The purchase-money security interest's roots in conditional sales and derivative title explain the UCC drafters' attempt to limit the sums that can be part of a purchase-money security interest in Official Comment 3 to today's section 9-103. In its simplest sense, an obligation entitled to purchase-money priority was required to be "directly related to the acquisition of the property."[232] The reason for this direct

---

226. Grant Gilmore, *The Purchase Money Priority*, 76 HARV. L. REV. 1333, 1341 (1963).

227. *See id.* at 1338–40 (explaining the railroad cases but also noting that the idea of purchase money priority dates back to at least 1631); Hakes, *supra* note 224, at 328–34.

228. Hakes, *supra* note 224, at 335–36.

229. *Id.*

230. U.C.C. § 9-204 (2012–13).

231. WHITE & SUMMERS, *supra* note 89, § 25.4.

232. Gilmore, *supra* note 226, at 1345 (internal quotation marks omitted).

relationship was to prevent fraud upon the first lender. If purchase-money priority were granted only to the extent that funds were used to acquire property, the purchase-money lender could have priority in the goods up to that amount and the first lender could retain its security interest in any remaining equity.[233]

The foregoing discussion illuminates the purpose behind the list of purchase-money components in Official Comment 3, but it is completely irrelevant to consumer transactions. The UCC prohibits after-acquired property clauses in consumer loan agreements.[234] Without the floating lien, purchase-money status is irrelevant.

B. Why Official Comment 3's List of Price and Value Components Is Irrelevant in Consumer Transactions

The prohibition on floating liens over consumer goods has been in Article 9 since its inception, and is a relic of the drafters' original plan to include consumer protection in the UCC.[235] As a result, all secured consumer loans are tied to specific, identified assets. Although purchase-money secured parties enjoy superpriority status under the UCC, the super nature of the priority is irrelevant when the collateral is consumer goods because there cannot be a floating lien covering consumer goods. Because the UCC prohibits after-acquired property clauses that cover consumer goods, purchase-money priority in consumer goods is a false priority.

The 2001 Amendments to Article 9 provide further evidence that the UCC is not relevant in defining the extent of a purchase-money security interest in consumer goods. Today, Article 9 provides a detailed definition of the term "purchase-money security interest." Unlike the earlier versions of Article 9, the current version defines the extent of a purchase-money security interest when the purchase-money collateral secures an obligation that is not purchase money and when the security interest includes collateral that is not purchase-money collateral.[236] Purchase-money collateral secures a non-purchase-money obligation when the original loan is refinanced and the debtor borrows more money as part of the refinancing transaction, perhaps to repay another obligation.[237] For these types of loans, the UCC adopts a "dual

233. *Id.*; Hakes, *supra* note 225, at 340.

234. § 9-204(b).

235. 1 GRANT GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 11.6 (1965).

236. § 9-103 (a), (b) (2012); *see supra* notes 42–43 and accompanying text.

237. Moringiello, *supra* note 8, at 866–67 (explaining purchase money transactions involving additional collateral and additional debt).

status" rule, under which a security interest can be partially purchase money and partially non-purchase-money.[238] For consumer goods transactions, however, the UCC is silent on whether the dual status rule or the alternative approach, the "transformation rule" under which a purchase-money security interest that includes non-purchase-money components is transformed in its entirety into a non-purchase-money security interest, applies.[239] The decision to remain silent on the treatment of a purchase-money debt that includes a non-purchase-money component was the result of the "consumer compromise" during the drafting process that resulted in the 2001 Amendments to Article 9. The effect of the consumer compromise is to allow courts to continue to develop rules to govern consumer transactions.[240] Article 9, therefore, does not define the extent of a purchase-money security interest in consumer goods when funds that are arguably not purchase money are involved.

Eight of the nine appeals courts addressing negative equity under the hanging paragraph ruled that the amounts paid by the lender to pay off negative equity was part of the purchase-money obligation, and therefore did not find any need to apply the dual status or transformation rule.[241] Only the Ninth Circuit did, accepting the BAP's decision to apply the dual status rule.[242] Using the language of Official Comment 3 to find that a negative equity loan is fully secured seems to contradict the UCC's recognition that many purchase-money loans include a non-purchase-money component.

All of the appeals courts curiously disregarded another Official Comment to section 9-103. Article 9's treatment of purchase-money security interests in consumer transactions sends a clear message to bankruptcy courts that for bankruptcy purposes, purchase-money security interests are a federal law problem. This message is in the Official Comments to section 9-103—the very same set of Official Comments relied on by the courts for the proposition that Article 9 should define the extent of a purchase-money security interest in an automobile for hanging paragraph purposes. Official Comment 8

238. § 9-103(f), -103(f) cmt. 7.a; WHITE & SUMMERS, *supra* note 89, § 25-4.

239. U.C.C. § 9-103(h).

240. *See, e.g.*, §§ 9-103, -103 cmt. 8, -626, -626 cmt. 4; *see also* Marion W. Benfield, Jr., *Consumer Provisions in Revised Article 9*, 74 CHI.-KENT L. REV. 1255, 1259 (1999) (describing negotiations that resulted in consumer compromise); Richard H. Nowka, *Allowing Dual Status for Purchase-Money Security Interests in Consumer Goods Transactions*, 13 TRANSACTIONS 13, 32–35 (2011) (describing the compromise on the dual status rule).

241. *See supra* notes 35–36 and accompanying text.

242. *Americredit Fin. Servs., Inc. v. Penrod* (*In re Penrod*), 611 F.3d 1158, 1160 n.2 (9th Cir. 2010).

explains the choice of the drafters of the UCC that it remains silent on whether the transformation rule or dual status rule should be applied in consumer transactions involving a security interest that is partially purchase money and partially non-purchase-money.[243] Noting § 522(f) of the Code, which allows debtors in bankruptcy to avoid certain nonpossessory, non-purchase-money security interests in listed consumer goods, the Official Comment recognizes that the Bankruptcy Code does not expressly adopt the UCC definition of purchase-money security interest and stresses that where "federal law does not defer to this Article, this Article does not, and could not, determine a question of federal law."[244]

The foregoing discussion illustrates that Official Comment 3 to section 9-103 should provide no help in determining the extent of a purchase-money security interest in consumer goods. First, the Official Comments to section 9-103 caution readers away from using section 9-103 to resolve bankruptcy questions.[245] Second, although a security interest is a state law property interest entitled to protection in bankruptcy, and purchase-money status is a priority status that bankruptcy law respects, there is no such priority status when the collateral in question is consumer goods. Because purchase-money status carries no priority under state law, it is not a bankruptcy entry right subject to a *Butner* analysis. In addition, the irrelevance of purchase-money status under state law removes any *Kimbell Foods* presumption that state commercial law provides the appropriate federal rule of decision for interpreting the hanging paragraph. As a result, courts are free to use a federal definition of purchase money based on bankruptcy policy. In the next section, I will discuss the BAP opinion in *Penrod*. In that opinion, the court ultimately limited the extent of a purchase-money security interest by applying bankruptcy policy, but took the extra step of defining the term "purchase money security interest" according to state law,[246] a step that may have prevented the Supreme Court from settling the question of whether the hanging paragraph prevents bifurcation of negative equity loans.

---

243. § 9-103 cmt. 8.

244. *Id.* The Ninth Circuit BAP opinion in *Penrod* relied on this comment to adopt the dual status rule as a federal rule in negative equity cases. *Americredit Fin. Servs., Inc. v. Penrod* (*In re Penrod*), 392 B.R. 835, 853–60 (B.A.P. 9th Cir. 2008).

245. § 9-103 cmt. 8.

246. *Penrod*, 392 B.R. at 844.

VI. DEFINING PURCHASE MONEY IN LIGHT OF BANKRUPTCY POLICY: THE BAP OPINION IN *PENROD* ALMOST DOES IT

Because neither *Butner* nor *Kimbell Foods* requires that the state law definition of purchase-money security interest be imported into the hanging paragraph, bankruptcy policy should guide courts in defining purchase-money security interest for that purpose. The BAP in *Penrod* ultimately decided that the treatment of a security interest that is part purchase money and part non-purchase-money should be decided according to federal law,[247] but started by using state law to define purchase-money security interest. In this Part, I will first discuss the bankruptcy policies that should shape the definition of purchase-money security interest for hanging paragraph purposes. I then explain that although the *Penrod* BAP ultimately reached the right result from a policy perspective, it should have framed the issue as one of federal law rather than a mixed question of federal and state law.

A. Defining Purchase-Money Security Interest in Light of Bankruptcy Policy

Because purchase-money status in consumer goods confers a bankruptcy exit right, its definition should be consistent with both the general policies of the Bankruptcy Code and the stated policies underlying BAPCPA. The two commonly stated goals of consumer bankruptcy are to provide equal treatment of similarly situated creditors[248] and relief for the honest but unfortunate debtor.[249] The equal treatment of creditors is essential to the collective nature of bankruptcy and relief for individual debtors, through the discharge provisions, is essential to the debtor's fresh financial start. The poorly drafted BAPCPA amendments announce two purposes in their name: bankruptcy abuse prevention and consumer protection.[250]

Because negative equity loans are underwater at the time they are made, their inclusion in the definition of purchase money conflicts with the core bankruptcy policy of equality among creditors. Lenders who extend negative equity financing are engaging in the same kind of lending as credit card companies in that they are making loans that, to the extent that they exceed the value of the vehicle purchased, are

---

247. *Id.* at 859–60.

248. TABB, *supra* note 13, § 1.1, at 1.

249. Margaret Howard, *A Theory of Discharge in Consumer Bankruptcy*, 48 OHIO ST. L.J. 1047, 1047 (1987).

250. Jean Braucher has suggested interpreting the 2005 BAPCPA amendments in light of their two stated purposes. Braucher, *supra* note 2, at 353.

unsecured. Giving such a lender full payment for the portion of its loan that was never supported by collateral is directly counter to the bankruptcy policy of equality in distribution.

Relief for the honest but unfortunate debtor can be viewed as a corollary to bankruptcy abuse prevention. The Code's discharge provisions refuse relief to the debtor who engaged in some kind of bad behavior either during or before the bankruptcy case.[251] In addition, some of the individual debts that the Code declares nondischargeable are debts that result from dishonest behavior of the debtor.[252]

The addition of the hanging paragraph to the Code clearly reflects the "bankruptcy abuse prevention" policy of BAPCPA. The abuse that the hanging paragraph aims to remedy is clear—Congress wanted to protect automobile lenders from losses caused by individuals who file for bankruptcy shortly after purchasing a car on credit. The lenders demanded protection because of the rapid depreciation of their collateral in the early years of a car loan.[253]

Including negative equity, however, tips the scales too far in the lenders' favor. The goal of preventing bankruptcy abuse must be balanced against that of providing relief for the honest but unfortunate debtor. The BAPCPA goal of preventing bankruptcy abuse is satisfied by protecting lenders against depreciation. The losses that lenders suffer due to negative equity loans are not due to depreciation, however, they are due to the fact that negative equity loans are underwater at the time they are made. Lenders voluntarily make these underwater loans knowing both the value of the trade-in vehicle and the amount of the outstanding loan secured by that vehicle.[254] Therefore, their losses are not caused by any debtor wrongdoing.

Inclusion of negative equity financing in the definition of purchase money is not necessary to further the policy of bankruptcy abuse prevention, and it is contrary to the goal of protecting the honest but unfortunate debtor. The Code's discharge provisions address abuse by debtors. For example, if a creditor incurs losses because a debtor

---

251. *See, e.g.*, 11 U.S.C. § 727(a)(3) (2006) (denying the discharge to a debtor who has concealed or falsified his financial records); § 727(a)(4) (denying the discharge to a debtor who has knowingly and fraudulently presented a false claim in connection with the case).

252. *See, e.g.*, § 523(a)(2) (debts obtained by a false representation or actual fraud are nondischargeable); § 523(a)(4) (debts arising from fraud or defalcation while acting in a fiduciary capacity are nondischargeable).

253. *See supra* notes 211–219 and accompanying text.

254. *See supra* notes 27–31 and accompanying text.

misrepresented her ability to pay, the Code punishes that debtor by making that debt nondischargeable.[255]

A federal definition of "purchase-money security interest" for hanging paragraph purposes should include only the amounts that every buyer would be required to pay for the collateral in question. The definition should be based on the retail price of the automobile, and could borrow from language already in § 506 of the Code. In § 506, the Code values consumer goods at their replacement value, which is further defined as the "price a retail merchant would charge for property of that kind considering the age and condition of the property."[256] For hanging paragraph purposes, a "purchase-money security interest" could be defined as a security interest that secures the price that the retail merchant in question charges all buyers of like property. Such a definition would necessarily exclude negative equity financing because not all buyers require negative equity financing to purchase their vehicles. Protecting a lender up to the amount of the retail price furthers both the policy of bankruptcy abuse prevention and that of giving relief to the honest but unfortunate debtor. By giving the lender the maximum amount it would have realized on foreclosure had it foreclosed on the car when it was at its highest value, such a federal definition would both protect the lender against depreciation and protect debtors who did nothing wrong in incurring the debt to buy the car. Moreover, this definition would be consistent with the bankruptcy principle of equality: it would treat a claim that was unsecured at its inception as an unsecured claim.

B. The Penrod *BAP Opinion*

Ultimately, the BAP in *Penrod* held that the hanging paragraph treatment of a purchase-money security interest should be dictated by federal policy.[257] In doing so, however, the BAP took a two-step approach to determining the extent of a purchase-money security interest for hanging paragraph purposes. First, the court defined the term "purchase money security interest" with reference to state law.[258] Then, once it determined that the satisfaction of negative equity is not included in the definition of purchase money, it held that, as a matter of

---

255. § 523(a)(2) (excepting from discharge a debt that is obtained by a false written statement respecting the debtor's financial condition if the creditor reasonably relied on the statement).

256. *Id.*

257. *Americredit Fin. Servs., Inc. v. Penrod* (*In re Penrod*), 392 B.R. 835, 855–56 (B.A.P. 9th Cir. 2008).

258. *Id.* at 852.

federal law, the 910 lender's security interest could be divided into a purchase-money portion and a non-purchase-money portion, thus adopting the dual status rule that the UCC adopts for nonconsumer transactions.[259]

The court gave tremendous deference to state law, relying on *Kimbell Foods* and *Kamen v. Kemper Financial Services, Inc.*[260] for the proposition that a court should fill the gaps in federal remedial schemes with uniform federal rules "only when the scheme in question evidences a distinct need for nationwide legal standards."[261] It then relied on Official Comment 3 to UCC section 9-103 to find that the satisfaction of negative equity is "nothing more than a refinancing of the preexisting debt owed on the trade-in" and thus not included in the laundry list of items that the Official Comment includes in the price or the value given to enable the purchase of collateral.[262] As a result, the lender's purchase-money security interest was limited to the amount of its claim not allocable to negative equity.[263]

After the court determined that the negative equity financing was not part of the purchase-money security interest, it turned to the question of whether the existence of non-purchase-money debt transformed the entire claim into a non-purchase-money claim exempt from the operation of the hanging paragraph. In holding that it did not, the court devised a federal rule adopting the dual status rule under which the purchase-money portion of the 910 lender's claim is protected from cram down by the hanging paragraph and the negative equity portion is treated as an unsecured deficiency.[264]

In applying a federal dual status rule for 910 loans, the BAP made three important observations about the hanging paragraph. The court first observed that the hanging paragraph is intended to be applied in a uniform manner, so the treatment of a claim that is part purchase money and part non-purchase-money should be a matter of federal, not state, law.[265] This observation enabled the court to give less deference to state law under a *Kimbell Foods* analysis. The UCC, however, refuses to prescribe a state rule regarding the treatment of such a

259. *Id.* at 859–60.

260. 500 U.S. 90 (1991).

261. *Penrod*, 392 B.R. at 843 (quoting *Clearfield Trust Co. v. United States*, 318 U.S. 363, 366–67 (1943)).

262. *Id.* at 852.

263. *Id.* at 860.

264. *Id.* at 857–59.

265. *Id.* at 855–56.

security interest,[266] and although bankruptcy courts have applied both state and federal law to develop such a rule in bankruptcy cases, it is an issue that is important only in bankruptcy.[267] In the absence of a UCC rule, some of the courts applying state law to hybrid purchase-money and non-purchase-money loans for the purpose of § 522(f) have applied state consumer installment sales statutes to determine whether the state adopted the dual status rule or the transformation rule.[268]

The second observation was the recognition that Official Comment 8 to section 9-103 takes a hands-off approach to the treatment of hybrid debt in consumer goods transactions.[269] This observation further supported the court's decision to apply federal standards to the issue.

Third, and most importantly, the court compared the purpose of purchase-money status under the UCC with the purpose of such status under the hanging paragraph. Here, the court, without saying so, recognizes the difference between purchase-money status as a bankruptcy entry status, and purchase-money status as a bankruptcy exit status. It recognized the two purposes of purchase-money status outside of bankruptcy. First, the second-in-time, first-in-right priority status is an important state law position for creditors in business transactions.[270] This is the entry right that bankruptcy law must respect, pursuant to *Butner*.[271] Second, it recognized the automatic perfection benefit that is enjoyed by creditors with purchase-money security interests in consumer goods, but noted that such a benefit is not bestowed on automobile lenders.[272] The court then focused on the bankruptcy exit function of the hanging paragraph, recognizing that the purpose of the hanging paragraph was to protect car lenders from cram

266. *See* U.C.C. § 9-103(h) (2012–13) (stating that the UCC does not choose between the dual status rule and the transformation rule in consumer goods transactions and that courts should not draw any inference from the UCC's adoption of the dual status rule in all other transactions). The BAP opinion notes, however, that several states have adopted nonuniform versions of section 9-103 that omit section 9-103(h). *Penrod*, 392 B.R. at 855.

267. *See* Moringiello, *supra* note 8, at 886–87 (describing how courts have treated loans that are part purchase money and part non-purchase-money and explaining that purchase money status is irrelevant for consumer loans outside of bankruptcy).

268. *See, e.g.*, *Pristas v. Landaus of Plymouth, Inc.* (*In re Pristas*), 742 F.2d 797, 802 (3d Cir. 1984); *W.S. Badcock Corp. v. Banks* (*In re Norrell*), 426 F. Supp. 435, 436 (M.D. Ga. 1977). Before the 2001 amendments to Article 9, the UCC was silent as to the application of the dual status or transformation rule in all transactions. *See* U.C.C. § 9-107 (1995).

269. *Penrod*, 392 B.R. at 855–56.

270. *Id.* at 845–46.

271. *See supra* notes 109–126 and accompanying text.

272. *Penrod*, 392 B.R. at 845.

down when their borrowers filed for bankruptcy shortly after buying a car.[273]

After explaining the bankruptcy exit purpose of purchase-money status for 910 lenders, the court then relied on bankruptcy policy to choose the dual status rule over the transformation rule. The court's main focus was on the equal treatment of creditors. To the extent that the loan could be allocated to the purchase of a new car, the creditor should be treated as a secured creditor (with the hanging paragraph's benefits), but to the extent that it is a loan to refinance old debt, it should be treated like all other unsecured claims.[274]

Unfortunately, the BAP approach to the issue may have preserved nonuniformity for the time being. In order to apply the dual status rule, one must first find that part of the obligation is non-purchase-money. All of the appeals courts to address the issue, except for the Ninth Circuit, refused to find any non-purchase-money obligation.[275] Had the BAP moved its analysis of purchase-money status in consumer goods as solely a bankruptcy exit right to its discussion of the definition of purchase money as opposed to the treatment of partially purchase-money debt, perhaps more courts would have recognized that the definition of purchase-money status is one that should be resolved under federal law, not by resort to the UCC.

CONCLUSION

It is easy to assume, as many courts do, that property rights in bankruptcy are defined by state law. State law property rights are modified, however, in every bankruptcy case. Therefore, a more nuanced approach to the role of state law in defining the property rights of parties to a bankruptcy case should focus on the difference between bankruptcy entry rights, which are defined by state law, and bankruptcy exit rights, which can only be defined by bankruptcy law. The definition of these latter rights can incorporate state law rights, but only if the rules defining those rights are consistent with the policies underlying the Bankruptcy Code. The hanging paragraph provides a perfect vehicle by which to discuss those rights. Had courts viewed purchase-money status in consumer goods as a status that is relevant only for bankruptcy exit, perhaps the Supreme Court would have weighed in on the matter. For now, however, nonuniformity reigns in the world of the hanging paragraph.

273. *Id.* at 856–57.
274. *Id.* at 857–60.
275. *See supra* notes 35–79 and accompanying text.