

IN THE UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
Eastern Division

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U.S. BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO
CLEVELAND

In Re:

In Proceedings Under Chapter 13

DARYL LEE MACKLIN,

Case No.: 07-17509

Debtor.

Judge Randolph Baxter

MEMORANDUM OF OPINION AND ORDER

This matter before the Court is the “Objection to Confirmation of Chapter 13 Plan” filed by Honda Financial Services aka American Honda Finance Corp (HFS). HSF objects to the confirmation of Debtor’s Chapter 13 Plan based upon the valuation of the collateral pursuant to 11 U.S.C. § 1325. This is a core proceeding pursuant to 28 U.S.C. § 157(a) and (b), with jurisdiction conferred under 28 U.S.C. § 1334 and General Order 84 of this district. Upon completion of a duly noticed hearing and a review of the record generally, the following factual findings and conclusions of law are hereby rendered:

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The dispositive facts are undisputed. The Debtor purchased a 2004 Pontiac Grand Prix on September 23, 2006. The vehicle was financed by HSF. The Retail Installment Contract (R.I.C.) reflects the cash price of \$ 11,755.50 for the vehicle. The down payment on the R.I.C. included the trade-in value of a vehicle which was listed as \$8,500.00. The payoff on a loan secured by the trade-in is listed as \$10,895.00. This made the net trade-in to be a negative \$2,395.00. This negative equity along with GAP insurance in the amount of \$ 595.00 and a service contract in the amount of \$ 1,900.00 was also financed in the contract for a total of \$16,167.75.

The Debtor filed for Chapter 13 protection on October 4, 2007, which was less than 910 days after the subject financing. HFS filed its proof of claim in the amount of \$15,221.16. Debtor's plan proposes to pay HFS \$11,900.00 with an interest rate of 7% per annum. HFS objected to the Debtor's Chapter 13 plan of reorganization because the plan proposed to pay less than the full contract balance.

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HFS contends that it has a security interest in the 2004 Pontiac. Although its proof of claim was filed in the amount of \$15,221.16, HFS asserts that it is owed \$15,528.87 plus interest. It further argues that, pursuant to 11 U.S.C. § 1325 (a), the full amount of \$15,528.87 with an interest rate of 9.75% should be paid and no part of the transaction can be crammed down. This position is based upon the fact that the vehicle debt was incurred within the 910-day period preceding the filing of the Debtor's bankruptcy.

The Debtor contends that the refinance of the negative equity from the previous car loan (trade-in), the financing of GAP insurance and the service contract as part of the R.I.C. did not result in a purchase money security interest (p.m.s.i.) in favor of HFS. The Debtor argues that the trade-in was a separate and distinct transaction from his purchase of the Pontiac. Therefore, the Debtor contends these transactions were for the sale of the trade-in and the purchase of the Pontiac. Both transactions and their net financial result were then incorporated into the R.I.C. As such, Debtor contends that HFS's claim is limited to \$11,900.00 plus interest which is the unpaid portion of the purchase price of the Pontiac that now remains due and owing.

The Court must determine whether the hanging paragraph contained in 11 U.S.C. § 1325 (a) prohibits the bifurcation of the HFS claim into secured and non-secured portions and requires the Debtor to pay the full claim of HFS as a fully secured purchase money security interest even though part of the claim is for money loaned to pay off negative equity and to purchase GAP insurance and a service contract.

In pertinent part, Title 11 U.S.C. § 1325 (a) provides:

(a) Except as provided in subsection (b), the court shall confirm a plan if--

(5) with respect to each allowed secured claim provided for by the plan--

(A) the holder of such claim has accepted the plan;

(C) the debtor surrenders the property securing such claim to such holder;

(6) the debtor will be able to make all payments under the plan and to comply with the plan....

For purposes of paragraph (5), section 506 shall not apply to a claim described in that paragraph if the creditor has a purchase money security interest securing the debt that is the subject of the claim, the debt was incurred within the 910-day preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle (as defined in section 30102 of title 49) acquired for the personal use of the debtor, or if collateral for that debt consists of any other thing of value, if the debt was incurred during the 1-year period preceding that filing.

Title 11 U.S.C. § 506 provides in pertinent part:

(a)(1) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

The hanging paragraph of § 1325 (a) (5) has many different implications in regard to how a creditor's claim in the financed property of a debtor should be considered.

Section 1325 (a) (5) "specifies three ways in which a debtor may obtain court approval of a plan with respect to the treatment of secured claims: (1) obtain the creditor's acceptance of the plan; (2) "cram down" the claim pursuant to § 506 and pay it within the plan; or (3) surrender the collateral. Section 506 bifurcates secured claims into secured and unsecured portions, with the secured portion limited to the value of the collateral at the time of filing, and the unsecured portion equal to the difference between the collateral's value and the balance of the loan." *In re Quick*, 371 B.R. 459, 461-62 (10th Cir. 2007).

The first treatment of secured claims under § 1325 (a)(5)(A), i.e., to obtain the creditor's acceptance of the plan, is straightforward and uncomplicated. If the debtor is able to obtain the creditor's acceptance, the Plan proceeds toward confirmation.

However, the second and third treatment of secured claims has produced a myriad of court interpretations.

The Sixth Circuit Court of Appeals has very recently considered the interpretation of 11 U.S.C. §1325 (a)(5)C) as it relates to the remaining indebtedness when a debtor surrendered a vehicle in a Chapter 13 case purchased within the 910 days preceding the filing of a bankruptcy (number 3 above). The Sixth Circuit ruled that surrender cases subject to the hanging paragraph of § 1325 (a) should be analyzed by employing the pre-2005 bankruptcy law. The Court employed the common law principle of “the equity of the statute” to arrive at this conclusion for the surrender cases. *In Re Long*, 519 F. 3d 288, 298 (6th Cir. 2008). Therefore, the Sixth Circuit has a definitive interpretation of how to deal with the anti cram down provision of § 1325 (a)(5)(B) as it relates to surrendered property. The unresolved area related to this provision is in the determination of the treatment of creditor’s claim where the debtor retains the collateral.

“The hanging paragraph of § 1325 (a)(5) is often referred to as the ‘anti-cram-down’ or ‘anti-bifurcation’ paragraph because its most obvious function is to block bifurcation of a 910 Creditor’s lien into secured and unsecured portions so that a debtor who wishes to retain a 910 Vehicle under Section 1325 (a)(5)(B) must pay the full amount owing to the secured creditor without regard to the present value of the collateral.” *Long, supra, quoting In re Pinti*, 363 B.R. 369, 375 (Bankr. S.D. N.Y. 2007).

The courts are split on whether a 910 creditor’s lien can be bifurcated for the purpose of cram down when the amount financed includes other funds such as negative equity, insurance, etc. Some courts have taken the position that the anti cram down provision does not apply, even though there is a purchase money security interest, when

there are other factors to consider such as negative equity, insurance, etc. In those cases bifurcation for the purposes of cram down is permissible for all but the portion of the loan that was used to acquire the new vehicle and thus only funding for the new vehicle constituted purchase money security subject to the “hanging paragraph”. The courts made this determination by utilizing the state law provisions that defined the scope of purchase money security interest. See, *In re Osborn*, 363 B.R. 72, (B.A.P 8th Cir. 2007); *In re Kellerman*, 377 B.R. 302 (Bankr. D. Kan. 2007); *In re Acaya*, 369 B.R. 564 (Bankr. N.D. Cal. 2007); *In re Hayes*, 376 B.R. 655 (Bankr. M.D. Tenn. 2007).

Other courts have taken the position that the negative equity and other amounts financed makes the security interest “not a purchase money security interest and the hanging paragraph... does not apply to prevent the debtor from bifurcating the lenders claim for the purpose of cramming down the plan.” *In re Jackson*, 358 B.R. 560 (Bankr. W.D. N.Y. 2007); *In re Grant*, 2007 WL 417029 (Bankr. W.D. NY 2007); *In re Price*, 2007 WL 664534 (Bankr. E. D. N.C. 2007).

Still other courts have determined that the provisions of the hanging paragraph preclude the bifurcation of the amounts into secured and unsecured amounts. In those cases, although there are many underlying rationales that the various courts have relied on, the consensus is that the addition of negative equity, GAP insurance or other costs into the financing does not preclude the fact that the creditor holds a purchase-money security interest in the vehicle and therefore the amount could not be bifurcated for the purpose of cram down. See, *In re Trejos*, 352 B.R. 249 (Bankr. D. Nev. 2006); *In re Graupner*, 356 B.R. 907 (Bankr. M.D. Ga. 2006); *In re Murry* 352 B.R. 340 (Bankr. M.D. Ga. 2006); *General Motors Acceptance Corp. v. Peaslee*, 373 B.R. 252, (W.D.

N.Y. 2007); *In re Macon*, 376 B.R. 778 (Bankr. D. S.C. 2007); *In re Englewood*, 362 B.R. 696 (Bankr. E.D. Va. 2007); *In re Wall*, 376 B.R. 769 (Bankr. W.D.N.C. 2007); *In re Macon*, 376 B.R. 778 (Bankr. D. S.C. 2007); *In re Lorenz*, 368 B.R. 476 (Bankr. E.D. Va. 2007).

This Court earlier considered this issue and held that a bifurcated cram down is available under such circumstances. In the first *Westfall* case, the Court held that:

“[w]hen a transaction is mixed or has both purchase money and nonpurchase money components, the entire transaction is transformed into a nonpurchase money transaction as allowed by O.R.C. §1309(F). Thus, creditors’ loans to debtors are nonpurchase money transactions not subject to the hanging paragraph following 11 U.S.C. § 1325 (a) 9. Inapplicability of the hanging paragraph results in the permissible bifurcation of 910 vehicle claims under 11 U.S.C. § 506. In other words, the vehicle loans are subject to cramdown.”

In re Westfall, 365 B.R. 755, 764 (N.D. Ohio, 2007)

In arriving at this conclusion, the Court adopted a transformation rule that allowed it to adopt the Ohio definition of purchase money security interest.

The second *Westfall* ruling reconsidered the earlier holding. Affirming its earlier ruling that it is permissible to bifurcate into secured and unsecured for the purposes of cram down, the reasoning was changed. In the second *Westfall* case, the Court found that the bifurcation was appropriate under the “dual status rule” and stated that the “transformation rule was not apropos.” *In re Westfall*, 376 B.R. 210, 220 (N.D. Ohio, 2007).

A review of the dual status rule under Ohio law is instructive. The Ohio Uniform Commercial Code § 1309.103 (B), (F) and (H) states as follows:

(B) A security interest in goods is a purchase-money security interest:

(1) To the extent that the goods are purchase-money collateral with respect to that security interest;

(2) If the security interest is in inventory that is or was purchase-money collateral, also to the extent that the security interest secures a purchase-money obligation incurred with respect to other inventory in which the secured party holds or held a purchase-money security interest; and

(3) To the extent that the security interest secures a purchase-money obligation incurred with respect to software in which the secured party holds or held a purchase-money security interest.

(F) In a transaction other than a consumer-goods transaction, a purchase-money security interest does not lose its status as a purchase-money security interest, even if:

(1) The purchase-money collateral also secures an obligation that is not a purchase-money obligation.

(2) Collateral that is not purchase-money collateral also secures the purchase-money obligation. or

(3) The purchase-money obligation has been renewed, refinanced, consolidated, or restructured.

(H) The limitation in divisions (E), (F), and (G) of this section to transactions other than consumer-goods transactions is intended to leave to a court the determination of the proper rules in consumer-goods transactions. The court shall not infer from that limitation the nature of the

proper rule in consumer-goods transactions and may continue to apply established approaches.

The Ohio Uniform Commercial Code sets forth that a purchase money security interest does not lose its status even if the purchase money collateral also secures an obligation that is not a purchase money obligation. *See, O.R.C. §1309(F)(1)(2)*. This provides a basis for the ability to bifurcate the transaction utilizing the dual purpose rule. The Comments accompanying the Ohio Revised Uniform Commercial Code §1309.103 explain the aforementioned section, in pertinent part as follows:

7. Provisions Applicable Only to Non-Consumer-Goods Transactions.

a. "Dual-Status" Rule. For transactions other than consumer goods transactions, this article approves what some cases have called the "dual-status" rule, under which a security interest may be a purchase-money security interest to some extent and a nonpurchase-money security interest to some extent. (Concerning consumer-goods transactions, see subsection (h) and comment 8.) Some courts have found this rule to be explicit or implicit in the words "to the extent," found in former section 9-107 and continued in subsections (b)(1) and (b)(2). The rule is made explicit in subsection (e). For nonconsumer-goods transactions, this article rejects the "transformation" rule adopted by some cases, under which any cross-collateralization, refinancing, or the like destroys the purchase-money status entirely.

Consider, for example, what happens when a \$10,000 loan secured by a purchase-money security interest is refinanced by the original lender, and, as part of the transaction, the debtor borrows an additional \$2,000 secured by the collateral. Subsection (f) resolves any doubt that the security interest remains a purchase-money security interest. Under subsection (b), however, it enjoys purchase-money status only to the extent of \$10,000.

8. Consumer-Goods Transactions; Characterization Under Other Law.

Under subsection (h), the limitation of subsections (e), (f), and (g) to transactions other than consumer-goods transactions leaves to the court the determination of the proper rules in consumer-goods transactions. Subsection (h) also instructs the court not to draw any inference from this

limitation as to the proper rules for consumer-goods transactions and leaves the court free to continue to apply established approaches to those transactions.

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

A review of the facts of the present case under the Ohio U.C.C. provisions reveals that the transaction at issue in this case included a partial purchase money security interest. The Retail Installment Contract (R.I.C.) for the vehicle reflects the cash price of \$ 11,755.50. However, the down payment on the R.I.C. included the trade in of a vehicle which made the net trade-in to be a negative \$2,395.00. This negative equity along with GAP insurance in the amount of \$595.00 and a service contract in the amount of \$1,900.00 were all included in the financing and should be subject to the dual-status rule.

Thusly, the Court concludes that the subject transaction has purchase money components that are not destroyed by the payment of negative equity, GAP insurance and the service contract. In applying the dual-status rule, the Court finds that the transaction has purchase money components which will be secured and not subject to bifurcation under § 1325 (a) i.e., the amount that was used to purchase the vehicle. The Court further concludes that non-purchase money security interest components (the payment of

negative equity, GAP insurance, and the service contract) can be bifurcated and relegated to the status of general unsecured claims.¹

Accordingly, the subject objection is hereby overruled. The confirmation hearing will proceed for a determination of the remaining feasibility issues. Each party is to bear its respective costs.

IT IS SO ORDERED.

Dated, this 9th day of
June, 2008



**Judge Randolph Baxter
United States Bankruptcy Court
Northern District of Ohio**

¹ In *Westfall*, the Court utilized a “single percentage formula based upon the original transaction” to determine the amounts in each category. *Westfall*, supra at 219. In other words, the same percentage of the amount financed will be applied to the claim balance to determine the amount of the secured claim and the amount of the unsecured claim.