



THE EMPIRE STRIKES BACK!

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INTRODUCTION

Not so long ago, in a galaxy not so far away, competing forces battled against self-described good and evil. Those on the debtors' side labeled themselves as "Jedi" and the car lenders as the "Empire." These parties soon engaged in battle over new rules imposed under BAPCPA.

Early cases from the Bankruptcy Courts gave debtors "A New Hope" under various Chapter 13 BAPCPA provisions. Decisions on issues like "surrender in full", "negative equity" and "personal use" seemed to negate the seemingly impenetrable provisions of the new "hanging paragraph."

Unfazed by these Bankruptcy Court decisions, the "Empire Strikes Back" by appealing the issues to the Circuit Courts. That forum proved much more favorable to the Empire for interpreting the not so straightforward provisions of BAPCPA.

Will there be a "Return of the Jedi" to push back the Empire's success in the Circuit Courts? The Force is certainly strong in many of debtors' counsel and creative arguments continue to spring forth.

Have the car lenders achieved all they sought in BAPCPA? These materials examine the journey so far and provide case interpretations across the country.

ANALYSIS

I. SURRENDER IN FULL SATISFACTION

One of the first battles under BAPCPA was debtors' argument that plans could propose to surrender collateral in full satisfaction of the entire claim (resulting in no unsecured deficiency claim).

A. Statutory Provision

The "hanging paragraph" of Section 1325(a) provides:

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.

(emphasis added).

B. Early Bankruptcy Court Decisions

Relying on the *Ezell* line of cases, many debtors were successful in confirming plans in the bankruptcy courts containing a provision that surrendered vehicles in full satisfaction of the entire debt (eliminating any deficiency balance). The argument was that since the 910 claim couldn't be bifurcated under Section 506 into secured and unsecured components, the claim must be entirely secured and that the surrender of the collateral satisfied the entire secured claim. Since there was no unsecured claim, the debtor did not have to provide for any payment on the deficiency.

Early on, a majority of Bankruptcy Courts allowed confirmation of plans that provided for surrender in full. *See In re Rodriguez*, 375 B.R. 535 (9th Cir. BAP 2007) (collecting cases).

C. Circuit Courts Decisions

The Circuit Courts did not adopt this early majority view of the Bankruptcy Courts. Recently, the Fifth Circuit followed the prohibition of such a provision by the Fourth, Seventh, Eighth, Tenth, Eleventh and the outcome from the Sixth Circuit (disagreeing with its reasoning but following its result). *See In re Miller*, 570 F.3d 633 (5th Cir. June 5, 2009); *Tidewater Fin. Co. v. Kenney*, 531 F.3d 312 (4th Cir.2008); *In re Wright*, 492 F.3d 829 (7th Cir. 2007); *Capital*

One Auto Finance v. Osborn, 515 F.3d 817 (8th Cir. 2008); *In re Ballard*, 526 F.3d 634 (10 Cir. 2008); *In re Barrett*, 543 F.3d 1239 (11th Cir. 2008); *AmeriCredit Financial Services, Inc. v. Long (In re Long)*, 519 F.3d 288 (6th Cir.2008).

For the Circuit Courts, the issue rises and falls on the source of an unsecured claim. Finding the answer to that question lies not only in Section 506 – but under state law as well, the issue is quickly resolved. The Fifth Circuit’s analysis in *Miller* mirrors that of Judge Easterbrook in *Wright*.

“The *Wright* court, 492 F.3d at 832, recognized that the hanging paragraph does prevent § 506 from affecting surrendered 910 vehicles under § 1325(a)(5)(C). The court then properly explained that § 506 "is [not] the only source of authority for a deficiency judgment." *Id.* Instead, "state law determines rights and obligations when the Code does not supply a federal rule." *Id.* (citations omitted). Using that state law, the court found that the creditor still had an unsecured deficiency judgment it could assert against the debtor.”

There are still tiny pockets of the country where surrender in full may work. *In re Pruitt*, 401 B.R. 546 (D. Ct. 2009). Note that *Pruitt* also relied on an estoppel theory based on the creditor’s Proof of Claim. The result in *Pruitt* may be avoidable by making sure to state on the Proof of Claim that the claim may contain an unsecured component. Under the Circuit Court decisions, however, that should not be necessary.

Finally, we continue to see plans where debtors’ counsel include such a provision hoping not to draw an objection – relying on the binding effect of confirmation.

D. The Return of the Jedi? Objecting to the Deficiency Claims as Untimely

Believing in the power of the Force, several debtors’ counsel have formed a new line of attack: objecting to the amended claims as untimely (filed after the bar date). There are a few courts that have entertained such an argument. *See, e.g., In re McBride*, 337 B.R. 451 (Bankr. N.D. N.Y. 2006); *In re Matthews*, 313 B.R. 489 (Bankr. M.D. Fla. 2004). Those courts hold that the amended deficiency claim is essentially a new claim that does not relate back to the original secured claim.

One recent case specifically rejects this argument. *See In re Breaux*, Case No. 07-51007 (Bankr. W.D. La. 8/14/2009) (Bankr. W.D. La., 2009) (“Other courts, however, have held that a post-bar date amendment to assert an unsecured deficiency claim is permissible. *See Delmonte*, 237 B.R. 132, 135 (Bankr. E.D. Tex. 1999). In *Delmonte*, the court reasoned that the deficiency claim "relates to and arises out of the same transaction as the original claim." *Id.* at 136; see also, Lundin, *Chapter 13 Bankruptcy 3d Ed.* at Section 284. (noting that "one common example for appropriate use of an amended claim in a chapter 13 case might be the claim for a deficiency when collateral is repossessed and disposed of after confirmation.")).



Practice Tip: Reserve the right to file the deficiency claim on the face of the original Proof of Claim and or a motion for relief from stay. Alternative argument: Fine. Continue to pay the secured claim in full via *In re Adkins*, 425 F.3d 296 (6th Cir. 2005).

Conclusion on Surrender in Full:

Many plans still provide for surrender in full – hoping that the plans will not draw an objection. The vast majority of courts find that confirmation binds the creditor to the plan provisions upon confirmation – deeming silence is acceptance. Creditors should object to these plans to avoid having to argue that confirmation should be set aside or should not have been entered with such a patently impermissible provision.....

If a plan containing such a provision is confirmed, you will most likely be bound by its provisions. Any argument for revoking confirmation will be difficult – at best. After a plan has been confirmed, you must seek to revoke confirmation under Section 1330. The allegation has to be that the confirmation order was procured by fraud. You would have to allege that the debtor represented to the Court that the plan met all of the confirmation requirements and complied with the Code - and that was a fraud because this was a 910 claim that could not be crammed down. Under the Rules, this is supposed to be done in an adversary proceeding (see Rule 7001(5)).

In support of this argument, there are a couple of cases out of Utah that says that the Court should not confirm a case that doesn't comply with the Code [not providing for full payment of the 910 claim] – even if there is no objection from the creditor. *In re Garner*, 399 B.R. 267 (Bankr. D. Utah 2009); *In re Montoya*, 341 B.R. 41 (Bankr. D. Utah 2006). This may boil down to whether the judge believes that silence can be deemed as acceptance by a secured creditor. You might be able to use these cases to argue that this case should really not have been confirmed in the first place. Bottom line, this argument is tough to win.

II. NEGATIVE EQUITY (AND INSURANCE AND WARRANTY FINANCING)

J.D. Power and Associates estimates that approximately 38% of new car buyers have negative equity (i.e., they owe more than the value of the current vehicle) at trade-in, compared to 25% two years ago. Wilson & DiChiara, *The Changing Landscape of Indirect Automobile Lending*, FDIC Supervisory Insights, Summer 2005 at 29. Resolution of the negative equity issue, therefore, represents LOTS of money to car lenders in Chapter 13 cases.

One report has indicated that it is not uncommon for the amount of negative equity financed to be \$10,000 to \$15,000. Kiley, *Car Buyers Burned By Negative Equity*, USA Today, July 6, 2003, available at http://www.usatoday.com/money/autos/2003-07-06-car-loan_x.htm ("Mark Eddins of Friendly Chevrolet in Dallas estimates that 90% of his customers are upside-down, often owing \$10,000 to \$15,000 more than the trade-in is worth"). Assuming that 38% of the Chapter 13 cases have this level of negative equity, the amount at issue (if they did not surrender the vehicles) would be in excess of **\$350,000,000.00 per year**. (In 2008, there were approximately 358,000 chapter 13 cases).

A. Relevant Statutory Provisions of the UCC

Section 9-103 provides:

(a) In this section:

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

(2) "Purchase-money obligation" means 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.

(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;

....

Official Comment 3 to Article 9 states:

As used in subsection (a)(2), the definition of "purchase-money obligation," the "price" of collateral or the "value given to enable" includes obligations for expenses incurred in connection with acquiring rights in the collateral, sales taxes, duties, finance charges, interest, freight charges, costs of storage in transit, demurrage, administrative charges, expenses of collection and enforcement, attorney's fees, and other similar obligations.

The concept of "purchase-money security interest" requires a close nexus between the acquisition of collateral and the secured obligation. . . .

B. Early Bankruptcy Court Decisions

Results of negative equity challenges in the Bankruptcy Courts were mixed. Many of the Bankruptcy Courts found that a car lender's financing of negative equity either destroyed or limited the purchase money security interest. *See, e.g., In re Brodowski*, 391 B.R. 393 (Bankr. S.D. Tex. 2008) (Characterizing the purchase and satisfaction of the lien on the trade-in vehicle as two separate transactions that do not bear a close nexus).

C. Circuit Court Decisions

Like the surrender in full issue, the Circuit Courts have unanimously sided with the car lenders on the negative equity issue. Recently, the Fifth Circuit joined the other Circuits (4th, 8th, 10th and 11th) in finding that the negative equity, gap insurance and warranties were all included in the purchase money security interest. *See Ford Motor Company, LLC v. Rebecca Ann Dale (In re Dale)*, ___ F.3d ___, No. 08-20583 (5th. Cir. 9/8/2009) (5th. Cir. September 8, 2009) following *Graupner v. Nuvelt Credit Corp. (In re Graupner)*, 537 F.3d 1295, 1302 (11th Cir. 2008); *In re Price*, 562 F.3d 618 (4th Cir. 2009); *Ford v. Ford Motor Credit Corp. (In re Ford)*, ___ F.3d ___, No. 08-3192 (10th Cir. 8/3/09); *In re Mierkowski*, ___ F.3d ___, No. 08-3866 (8th Cir. 9/8/2009). The Second Circuit recently followed as well. *Reiber v. GMAC, LLC, Ford Motor Credit Company, General Motors Acceptance Corporation, Sovereign Bank, HSBC Auto Finance (In re Peaselee)*, ___ F.3d ___, No. 07-3962-bk(L) (2nd Cir. 10/9/2009)

The decision in *Dale* was based on both prongs of the purchase money security interest analysis (price and value given to enable). First, the Fifth Circuit believed that negative equity financing, gap insurance, and extended warranties are properly considered expenses incurred by the creditor in connection with the buyer's goal of acquiring rights in the collateral (and therefore part of the price). Second, noting that "obligations for expenses incurred in connection with acquiring rights in the collateral" as a stand alone category of expense, they found that negative equity and related expenses fit perfectly within the "value given to enable" prong of § 9.103.

Most of the Circuit Court decisions were limited to negative equity financing. *Dale*, however, found that not only was negative equity part of the purchase money security interest, but **gap insurance and service warranties** financed at the time of the original loan were also included in the purchase money security interest.

Note: Both *Dale* and *Mierkowski* stressed the importance of **unified decisions** from the Circuit Courts. *In re Dale* at footnote 8 ("Our conclusion is bolstered by general prudential concerns with creating unnecessary circuit splits. *See Alfaro*

