SO ORDERED,

Judge Neil P. Olack
United States Bankruptcy Judge
Date Signed: September 6, 2016

**The Order of the Court is set forth below. The docket reflects the date entered.**

**UNITED STATES BANKRUPTCY COURT**
**SOUTHERN DISTRICT OF MISSISSIPPI**

**IN RE:**

| | |
|---|---|
| **FRANKIE LEE SPEARS AND JUDY L. SPEARS,** | **CASE NO. 16-00575-NPO** |
| **DEBTORS.** | **CHAPTER 13** |

**ORDER SUSTAINING OBJECTION TO SECURED CLAIMS AND OTHER RELIEF AND REQUIRING AMENDED PLAN**

This matter came before the Court for hearing on June 27, 2016 (the "Hearing"), on the Objection to Secured Claims and Other Relief (the "Objection") (Dkt. 15) filed by the debtors, Frankie Lee Spears and Judy L. Spears (the "Debtors"), and the Proof of Claim (the "POC") (Bankr. Cl. 3-1), filed by Byars Furniture Company, Inc. ("Byars") in the above-styled chapter 13 bankruptcy case (the "Bankruptcy Case"). At the Hearing, Douglas M. Engell represented the Debtors and Samuel J. Duncan ("Duncan") appeared on behalf of J.C. Bell, the chapter 13 trustee (the "Trustee"). After fully considering the matter, the Court finds as follows:

**Jurisdiction**

The Court has jurisdiction over the parties to and the subject matter of the Bankruptcy Case pursuant to 28 U.S.C. § 1334. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(B). Notice of the Objection was proper under the circumstances.

**Facts**

1. The Debtors initiated the Bankruptcy Case by filing a voluntary petition for relief pursuant to chapter 13 of the Bankruptcy Code on February 23, 2016 (the "Petition") (Dkt. 1).

2. The Debtors filed their Chapter 13 Plan (the "Plan") (Dkt. 2) contemporaneously with the Petition. In the Plan, the Debtors indicated that Byars held a secured claim for a purchase money security interest ("PMSI") in furniture. (Plan at 2). According to the Plan, the Debtors owed Byars $1,000.00 for the furniture, and the furniture had a value of $300.00. (*Id.*).

3. In the Objection, the Debtors proposed to pay the $1,000.00 amount owed to Byars at 5.00% interest over the life of the Plan. (Obj. at 1). In the event that Byars was to timely file a proof of claim evidencing a PMSI acquired "less than (1) year before the petition filing, pay the amount owed as set forth in such claim plus 5% interest," or, if Byars was to file a proof of claim evidencing a PMSI acquired "more than (1) year before the petition filing, then pay the value of $300.00 plus 5% interest over the life of the plan . . . ." (*Id.*).

4. Byars filed the POC on March 15, 2016, listing the amount and value of its claim at $2,105.92 for "Purchase money loaned" at a fixed annual interest rate of 16.89%. (POC at 2). According to the POC, Byars's claim is secured by "Household goods" and was perfected by a "Retail Installment and Security Agreement." (*Id.*). According to the three (3) Retail Installment and Security Agreements (the "Security Agreements") attached to the POC (POC at 7-9), the Debtors purchased (1) an Ashley Sectional (the "Sectional") on April 16, 2014 (POC at 9); (2) a "4/6 Rufino Matt. Only" (the "Mattress") on July 3, 2014 (POC at 8); and (3) "2800 Washer" and a "220 Dryer" (the "Washer and Dryer") on July 7, 2015 (POC at 7). According to the Security Agreements, the purchase price was payable in monthly installments with interest, and Byars retained a PMSI in the items listed on the Security Agreements. Also attached to the

POC was the revolving accounts receivable ledger (the "Ledger") (POC at 5-6), which indicates the balance on the Debtors' account and the payments credited towards the balance.

5. At the Hearing, Duncan asserted the Trustee's position that the POC is for a revolving credit account, meaning that it has some elements of a 910 claim[1] and some elements that are not.

**Discussion**

Because the collateral for the POC is furniture rather than a motor vehicle, bifurcation will be precluded if the debt was incurred during the one (1) year preceding the Petition date.[2] In the Bankruptcy Case, the Petition was filed on February 23, 2016. The Debtors purchased the Sectional on April 16, 2014, and the Mattress on July 3, 2014, both more than one (1) year before the Petition date. The Washer and Dryer, however, were purchased on July 7, 2015, less than one (1) year before the Petition date. Accordingly, the Court must determine whether bifurcation of a secured claim is permitted when a portion of the debt was incurred more than one (1) year before the Petition date and a portion was incurred less than one (1) year of the Petition date.

The parties do not dispute that Byars has a secured claim. Section 1325(a)(5)[3] provides

[1] The so-called "hanging paragraph" that immediately follows 11 U.S.C. § 1325(a)(9), which provides the basis for a "910 claim," precludes bifurcation of a secured claim if: (a) the creditor has a purchase money security interest securing the debt that is the subject of the claim; (b) the debt was incurred within 910 days prior to filing the petition; (c) the collateral is a motor vehicle; and (d) the motor vehicle was acquired for the debtor's personal use. 11 U.S.C. § 1325(a). Additionally, bifurcation of a secured claim is precluded "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." *Id.*

[2] *See supra* note 1.

[3] Hereinafter, all code sections refer to the Bankruptcy Code found in title 11 of the U.S. Code unless specified otherwise.

for the permitted treatment of secured claims in a chapter 13 plan. A chapter 13 plan cannot be confirmed unless secured creditors (a) accept the plan; (b) receive their collateral by way of abandonment; or (c) "[are] paid, with interest, an amount equal to the value of the collateral securing the debt over the life of the plan, with the creditor retaining its lien on the collateral." *In re Shaw*, 209 B.R. 393, 394 (Bankr. N.D. Miss. 1996) (citing § 1325). "Two acceptable treatments—surrender of the collateral underlying the claim and treatment accepted by the creditor—are not affected by the ["hanging paragraph"][4]." *In re Steele*, No. 08-40282-DML-13, 2008 WL 2486060, slip op., at *2 (Bankr. N.D. Tex. June 12, 2008). Section 1325(a)(5)(B), on the other hand, "allows a plan to provide for payment of a secured claim through periodic payments including interest at a rate providing to the creditor the present value of the secured claim." *Id.* This provision, commonly known as the "cramdown provision," is subject to the "hanging paragraph" and, "when read with section 506(a)(1) of the Code ordinarily allows a debtor to retain property that secures a creditor's claim by payment to the creditor over time of the present value of the lesser of the claim or the collateral's value." *Id.* (footnotes & citation omitted). By removing § 506 from the operation of § 1325(a)(5), the "hanging paragraph" "limits cramdown treatment to that which provides a creditor, to the extent qualifying for treatment under [the "hanging paragraph"], with the present value of the creditor's claim, regardless of the value of the collateral." *Id.*

Overall, the goal of the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") was to reduce bankruptcy abuse. *In re Busby*, 393 B.R. 443, 452 (Bankr. S.D. Miss. 2008). Specifically, "[i]n the uninformed rush by Congress to prevent bankruptcy abuse, § 1325(a) of the Bankruptcy Code was amended by BAPCPA to include a paragraph at the end

---

[4] *See supra* note 1.

of § 1325(a)(9)." *Id.* at 295 n.7 (citation omitted). "The hanging paragraph was a specific remedy to a perceived abuse by debtors who purchased new vehicles [or any other thing of value] shortly before filing bankruptcy." *In re Busby,* 393 B.R. at 452. While the "hanging paragraph" is most often applied to vehicles purchased within 910 days of filing for bankruptcy, it also applies to "any other thing of value, if the debt was incurred during the 1-year period preceding that filing." 11 U.S.C. § 1325(a). The legislative history regarding the "hanging paragraph," "although not expansive, does indicate that it was meant to discourage bankruptcy abuse." *In re Duke,* 345 B.R. 806, 809 (Bankr. W.D. Ky. 2006). "The only clear intent discerned from the legislative history on the hanging paragraph is that Congress intended to provide more protection to creditors with purchase money security interests." *Id.*

Pursuant to the hanging paragraph, "[s]ecured debts falling within the hanging sentence must be treated as fully secured by the plan—without regard to the actual value of the collateral." Keith M. Lundin & William H. Brown, CHAPTER 13 BANKRUPTCY, 4TH EDITION, § 103.1, at ¶ 5, SEC. REV. Nov. 10, 2010, www.ch13online.com. Because Byars' secured claim partially falls within the "hanging paragraph" and partially falls outside of it, the question is whether the entire claim, or just the part that falls within the one (1)-year time frame provided by the "hanging paragraph," must be treated as secured. There are two (2) approaches that various courts have adopted in regard to the treatment of claims similar to the POC in the Bankruptcy Case: the transformation rule and the dual status rule.

Under the transformation rule, "if collateral is used to secure a debt other than its own purchase price, the creditor's original purchase money security interest in the collateral is transformed into a nonpurchase money security interest." *In re Shaw,* 209 B.R. at 396. In other words, "[u]nder the transformation rule, the secured creditor does not have a PMSI because the

non-purchase money component . . . transforms the entire claim into a non-purchase money security interest." *In re Busby*, 393 B.R. at 448 n.5. Conversely, pursuant to the dual status rule, "[a] security interest may be a purchase-money security interest to some extent and a non-purchase money security interest to some extent." *Id.* at 450-51 (citation omitted). Thus, if the Court applies the transformation rule in regard to the time constraint provided by the "hanging paragraph," the fact that part of the debt was incurred outside of the one (1)-year preceding the Petition date would transform the entire claim into a claim subject to § 506. If the Court adopts the dual status rule, on the other hand, the secured claim could be bifurcated and the Debtors could be required to pay value of the collateral for the portion of the debt incurred outside of the one (1) year preceding the Petition date, and pay the amount owed for the debt incurred within the one (1) year preceding the Petition date.

**I. Transformation Rule**

No court within the Fifth Circuit Court of Appeals has addressed the specific issue before this Court—how to treat a claim when a portion of it falls inside of the one (1)-year time period provided by the "hanging paragraph," and a portion falls outside of it. Preceding the inception of the "hanging paragraph" in 2005, the Fifth Circuit Court of Appeals in *In Roberts Furniture Co. v. Pierce (In re Manuel)*, 507 F.2d 990 (5th Cir. 1975) adopted what has since become known as the transformation rule, although not using that term. Later decisions interpreting the *In re Manuel* decision have unanimously concluded that the Fifth Circuit applied the transformation rule. *See e.g., Billings v. Arco Colo. Indus. Bank (In re Billings),* 838 F.2d 405, 407 (10th Cir. 1988); *Pristas v. Landaus of Plymouth, Inc.,* 742 F.2d 797, 800 (3d Cir. 1984); *Gillie v. First State Bank of Morton (In re Gillie),* 96 B.R. 689, 692-93 (N.D. Tex. 1989); *In re Gonzales,* 206 B.R. 133, 136 (N.D. Tex. 1997); *In re Palmer,* 123 B.R. 218, 221 (N.D. Tex.

1991); *In re Brodowski*, 391 B.R. 393, 402 (S.D. Tex. 2008).

In *In re Manuel,* the debtor purchased various pieces of furniture on a revolving account similar to the arrangement the Debtors had with Byars in the Bankruptcy Case. *Id.* at 991-92. The debtor originally purchased household furniture from the creditor, then, through a subsequent transaction, purchased several other items. *Id.* Those later purchases referenced the previous transaction and added the balance to the total of the new purchases. *Id.* The question presented to the Fifth Circuit was whether the entirety of the rolling account was PMSI, or only the final transaction. *Id.* at 992.

The problem recognized by the Fifth Circuit regarding the revolving account in *In re Manuel* is the same one the Court faces: "[t]he problem here begins with the fact that the security agreement filed with the court shows about $150 paid on about $900 total debt, for 7 pieces of furniture and a TV set, with no clues as to what items are paid for and which are not . . . ." *Id.* at 993. Based on the evidence presented to it, the Fifth Circuit was only able to trace the PMSI to the last purchase made. *Id.* According to the Fifth Circuit, state law,[5] which governs PMSI, requires the "purchase money security interest to be in the item purchased, and that . . . the purchase money security interest cannot exceed the price of what is purchased in the transaction wherein the security interest is created . . . ." *Id.* "[T]he interest here is not a 'purchase money security interest' because it is not taken or retained by the seller of the collateral solely to secure all or part of its price." *Id.* Thus, the Fifth Circuit determined that the creditor only had a PMSI arising from the final installment contract. *Id.* Having determined that the creditor's claim was

[5] The Fifth Circuit applied Georgia state law. The Supreme Court has held that state law applies in bankruptcy court to allocate priorities among creditors. *Lewis v. Mfrs. Nat'l Bank of Detroit,* 364 U.S. 603 (1961). Therefore, Mississippi state law governs the issue at hand in the Bankruptcy Case. In *In re Shaw*, the bankruptcy court noted that the Fifth Circuit in *In re Manuel* construed the Georgia Commercial Code, "which had language identical to that of the Mississippi Code . . . ." *In re Shaw*, 209 B.R. at 395.

partially a PMSI and partially a non-PMSI, the Fifth Circuit held that because collateral was used to secure debt other than its own purchase price, the creditor's original PMSI in the collateral was transformed into a nonpurchase money security interest. *Id.* at 993-94.

Citing *In re Manuel*, our sister bankruptcy court applied the transformation rule based upon facts similar to the Bankruptcy Case in *In re Shaw*, 209 B.R. 393 (Bankr. N.D. Miss. 1996). The debtors in *In re Shaw* purchased household goods and furniture from the creditor on a revolving account. *Id.* at 394. Like the Debtors in the Bankruptcy Case, the debtors in *In re Shaw* had multiple separate installment contracts with the furniture company. *Id.* "With each succeeding purchase, the buyers executed a new contract, which incorporated not only the purchase price of the new merchandise, but also the balance remaining on the previous contract(s)." *Id.* Pursuant to their plan, the debtors proposed to pay the creditor as a secured creditor only to the extent of the value of the merchandise listed on the most recent contract, but the creditor objected, claiming that it was secured by a PMSI in all of the merchandise. *Id.*

Applying the Fifth Circuit's holding in *In re Manuel*, the bankruptcy court in *In re Shaw* concluded that the creditor only held a PMSI in the most recently acquired merchandise. *Id.* at 395. After concluding that the creditor only held a partially secured claim, the bankruptcy court had to determine whether to treat the entire claim as non-PMSI, or whether to treat the PMSI portion as secured and the non-PMSI portion as unsecured. *Id.* The bankruptcy court noted that the transformation rule adopted by the Fifth Circuit in *In re Manuel* contained language that left "the door open for an exception to apply if the facts of a specific transaction allow." *Id.* at 396. "Since *Manuel*, courts have recognized that a purchase money security interest can survive through successive sales agreements when express contractual language allocating payments is present, i.e., the purchase money security interest can be 'traced.'" *Id.* This exception, also

known as the dual status rule, "might apply when a seller contractually provides some method for determining the extent to which each item of collateral secures its purchase money." *Id.* (citing *Skinner's Furniture Store of Greenville, Inc. v. McCall (In re McCall),* 62 B.R. 57, 59 (M.D. Ala. 1985)). The bankruptcy court noted that in *In re McCall,* the installment contract provided for a "first-in, first-out" schedule by which "payments applied to goods in the order in which they were purchased," meaning that "old debts are paid in full before payments are applied to new debts." *Id.* The bankruptcy court adopted the transformation rule and concluded that the creditor provided no evidence of express contractual language allocating payments that would allow it to trace the PMSI. *Id.* at 397. Accordingly, the bankruptcy court concluded that the entire claim was tainted by the non-PMSI status of a portion of the debt, and, therefore, the entire claim was unsecured. *Id.*

## II. Dual Status Rule

Although it appears that courts that have considered the issue have consistently applied the transformation rule to revolving credit transactions, courts have applied the dual status rule to other types of debt. Although subsequent cases within the Fifth Circuit have applied the dual status rule in negative equity[6] cases, neither *In re Manuel* nor *In re Shaw* has been contradicted or overruled. In *In re Busby,* our sister bankruptcy court applied the dual status rule to a claim containing negative equity. 393 B.R. at 448. In *In re Busby,* when the debtors purchased a new vehicle for $29,128.73 (including a $5.00 inspection fee, $634.23 in sales tax, and a service contract of $800.00), they traded in their old vehicle and entered into an installment contract with

[6] The term "negative equity" is an undefined term of art. "It is a term commonly used in the automobile industry to describe the difference between a vehicle's outstanding loan balance and the vehicle's market value." *In re Busby,* 393 B.R. at 447 n.4. If a borrower owes $10,000.00 on his trade-in vehicle, for example, and "the lender on the second vehicles gives the borrower a credit of $8,000.00 for the trade-in, there is $2,000.00 of negative equity." *In re Brodowski,* 391 B.R. at 397 n.3.

Wells Fargo, which resulted in negative equity in the amount of $5,500.00. *Id.* at 445. After concluding that the negative equity did "not constitute part of the PMSI on the vehicle," the bankruptcy court adopted the dual status rule, holding that the PMSI portion of the claim would be subject to the "hanging paragraph," but the negative equity would not. *Id.* at 447-48. The bankruptcy court noted that the "hanging paragraph" was "a specific remedy to a perceived abuse by debtors who purchased a new vehicle [or other PMSI goods] shortly before filing bankruptcy, and then upon filing, strip[p]ed the secured claim down to the value of the vehicle." *Id.* at 452. Accordingly, "the most equitable solution to this problem is to exclude the negative equity from the protection of the hanging paragraph and to apply the dual-status rule to protect the proper amount of the PMSI held by the lender." *Id.* (quotation omitted).

Similarly, in *In re Brodowski,* the bankruptcy court applied the dual status rule in holding that the "hanging paragraph" could apply to a secured claim that fell partially within the "hanging paragraph" and partially outside of it. 391 B.R. at 402. The debtor in *In re Brodowski* traded in his old vehicle when he purchased a new one, resulting in negative equity. *Id.* at 395. The bankruptcy court held that negative equity is not an obligation secured by a PMSI but that, under the dual status rule, the PMSI portion of the claim could still be treated as secured pursuant to the "hanging paragraph." *Id.* at 402. In deciding to apply the dual status rule to negative equity, the bankruptcy court distinguished *In re Manuel* and other decisions that applied the transformation rule to consumer goods transactions, finding that "the situation in the case at bar (rolling negative equity into the purchase of a new vehicle) is significantly different from [those cases], which typically involve ongoing purchases such as furniture." *Id.*

## III. Transformation Rule Applicable to Revolving Credit

Although the Court is cognizant of the fact that the Courts applying the transformation

rule did so before 2005, when the BAPCPA was enacted, the post-BAPCPA cases that have addressed the issue have not done so in a factual context similar to the Bankruptcy Case. In *In re Manuel*, which is binding precedent regarding revolving credit accounts, the Fifth Circuit was tasked with determining the status of a creditor's claim when the debtors incurred the debt on a revolving account basis. On the other hand, the post-BAPCPA cases dealt with the status of the negative equity portion of a claim, and almost all of those cases involved the debtor's purchase of a new vehicle. The purpose of the hanging paragraph – which was to protect creditors from debtors who purchased goods and/or vehicles shortly before filing bankruptcy – is not frustrated by adopting the transformation rule in regard to revolving accounts. A debtor who has a revolving account with a creditor differs from a debtor who begins a lending relationship with a creditor shortly before filing for bankruptcy, incurs a significant amount of debt, immediately files for bankruptcy, and crams down the lien. In scenarios like the one presented in the Bankruptcy Case, where the Debtor and Byars had an ongoing relationship on a revolving account, the "hanging paragraph" is not frustrated by applying the transformation rule. As the bankruptcy court noted in *In re Brodowski* when it applied the dual status rule, rolling negative equity into the purchase of a new vehicle is "significantly different" from cases that "involve ongoing purchases such as furniture." *In re Brodowski*, 391 B.R. at 402. Because *In re Manuel's* holding that the transformation rule applies to revolving credit accounts is binding, the Court finds that the transformation rule applies in the Bankruptcy Case.

While the dual status rule may be the appropriate rule to apply to cases involving negative equity resulting from the purchase of a new vehicle, the Court finds that, based on the facts of the Bankruptcy Case, which are nearly identical to the facts of *In re Manuel* and *In re Shaw*, the transformation rule applies. Like the Fifth Circuit in *In re Manuel*, the Court is faced

with a revolving account and installment contracts that do not state which debt has been paid, or the remaining value for each individual installment. Additionally, as the bankruptcy court found in *In re Shaw*, the Court is unable to identify any contractual language that provides a method for determining the extent to which each item of collateral secures purchase money. In other words, while it is clear that the Washer and Dryer were purchased less than one (1) year of the Petition date and the Sectional and the Mattress were purchased more than one (1) year before the Petition date, the Court has no way to allocate the installment payments because the Security Agreements provide no basis for doing so.

The POC indicates that when the Debtors made a new purchase, the balance was carried forward and the price of the newly purchased item was added to the total. (POC at 5-6). For example, when the Debtors purchased the Washer and Dryer on July 7, 2015, the Ledger indicates that the purchase price of $1,745.59 was added to the $1,233.05 "Bal. forward" for a new total balance of $2,978.64. (POC at 5). The Ledger also indicates that when the Debtors made a payment, it was applied to the total balance of the account, with no indication of which collateral the payment was applied to. (*Id.*). According to the Ledger, the same process was followed when the Debtors purchased the Mattress. (POC at 6). Accordingly, there is no way to determine which portion of the remaining balance is attributable to the Washer and Dryer, which were purchased within one (1) year of the Petition date. Further, there is no language that provides for a "first-in, first-out" schedule, like the bankruptcy court noted in *In re Shaw*, that would allow the Court to apply the dual status rule.

The Court recognizes that the "purpose of the hanging paragraph is to remedy a perceived abuse by debtors who would purchase a new vehicle [or any other thing of value] shortly before, or even on the eve of, filing a bankruptcy petition and then immediately strip down the secured

claim of the vehicle lender as part of their Chapter 13 Plan." *In re Brodowski,* 391 B.R. at 402. The Debtors did not purchase a vehicle or a large amount of furniture shortly before filing for bankruptcy. Instead, the Debtors purchased four (4) pieces of furniture on a revolving account with Byars over the course of 1.5 years. Byars attempted to retain a claim secured by all of the collateral until the Debtors paid for all of the items, despite the fact that the Debtors had been making payments since they purchased the Sectional on April 16, 2014. (POC at 6). As the Ledger indicates, the Debtors made monthly payments, and presumably would have paid off the Sectional and/or the Mattress at some point. However, Byars carried the balance forward when they purchased the Washer and Dryer and consolidated the outstanding balance with the purchase price. As one court noted, the purpose of applying the transformation rule to revolving accounts such as the one in the Bankruptcy case is based on the "underlying policy . . . to prevent overreaching creditors from retaining title to all items covered under a consolidation contract until the last item purchased is paid for." *Borg-Warner Acceptance Corp. v. Tascosa Nat'l Bank,* 784 S.W.2d 129, 134-35 (Tex. App. 1990).[7] In consideration of both of the policies behind the "hanging paragraph" and the application of the transformation rule, the Court finds that, based on the facts of the Bankruptcy Case, the most equitable rule is the transformation rule.

Like the Courts in *In re Manuel* and *In re Shaw,* the Court is unable to determine which portion of the POC should be treated as secured and which part should be treated as unsecured. Essentially, the installments of the revolving account are indistinguishable because it is unclear which debts the Debtors' payments were applied to and what the balance of each installment is. Accordingly, the Court finds that when a claim involves a revolving account for the purchase of furniture, some of which falls within the "hanging paragraph" and some of which does not, and

[7] The court applied Texas state law.

there is no contractual provision providing a method to determine which collateral secures which purchase money, the transformation rule should apply so that none of the claim falls within the "hanging paragraph." The Court finds, therefore, that the Objection should be sustained and the Plan should be amended to provide for the "cramdown" of the entire amount of the POC. In other words, the Debtors should amend the Plan to treat Byars as fully unsecured.

IT IS, THEREFORE, ORDERED that the Objection is hereby sustained.

IT IS FURTHER ORDERED that the Debtors hereby have fourteen (14) days from the date of this Order in which to submit a modified plan consistent with this Order.

**##END OF ORDER##**