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Negative Externalities and Subprime Auto Financing: Time to Let the Hanging Paragraph Go(2)

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Abstract

Economists generally agree that when private transactions generate negative externalities (i.e. unintended harmful byproduct), government intervention is potentially necessary. Negative externalities are considered socially inefficient because they destroy market supply and demand equilibrium. The existence of negative externalities is therefore one of those rare occasions when government intervention in private transactions is justified. It follows that when the government does choose to intervene, its goal should be to remedy, not to encourage, negative externalities. This article identifies one bankruptcy rule, commonly known as the Hanging Paragraph in the Bankruptcy Code, 11 U.S.C. § 1325(a)(9), that violates the basic principle of the externality theory. The Hanging Paragraph rule and its judicial progeny encourage negative externalities by incentivizing excessive subprime auto financing transactions that impose enormous costs on not only the borrowers, but also society at large, costs not borne by auto lenders. A few commentators have criticized the Hanging Paragraph and its judicial progeny expanding its scope. This article contributes to the discussion by pointing out the incongruence between the Hanging Paragraph rule and government’s role as envisioned by the basic economic theory and advocates for the elimination of the rule on that basis.
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I. Introduction

Economists generally agree that when private transactions generate negative externalities (i.e. unintended harmful byproduct), government intervention is potentially necessary.\(^2\) Negative externalities are considered socially inefficient because they destroy market supply and demand equilibrium.\(^3\) The existence of negative externalities is therefore one of those rare occasions when government intervention in private transactions is justified.\(^4\) The government can intervene by enacting rules among other options to shape the transactions.\(^5\)

It follows that when the government does choose to intervene, its goal should be to remedy, not to encourage, negative externalities. This article identifies one bankruptcy rule, commonly known as the Hanging Paragraph in the Bankruptcy Code, 11 U.S.C. § 1325(a)(9),\(^6\) that seems to violate the basic principle of the externality theory. The


\(^3\) Gruber, supra note 1, at p. 146.

\(^4\) Id.

\(^5\) Id. at p. 137.

\(^6\) This paragraph is known as the Hanging Paragraph because when it was added to the Bankruptcy Code, it was not separately designated by a number or letter. In re Graupner, 537 F.3d 1295, 1296 (11t Cir. 2008) (“The section in question has been called the
Hanging Paragraph rule and its progeny encourage negative externalities by incentivizing excessive subprime auto financing transactions. The Hanging Paragraph makes car loans non dischargeable in a Chapter 13 individual bankruptcy under certain conditions if the loans qualify as purchase money security interest (hereinafter PMSI) loans, i.e. when borrowers obtained the loans to buy new cars. Non dischargeability of auto loans afforded by the bankruptcy rule reduces lenders’ incentive to monitor borrowers’ ability and willingness to pay back the loan. The reduced incentive will lead to excessive...
subprime auto financing transactions that impose enormous costs on not only the borrowers, but also society at large, costs not borne by auto lenders.

A few commentators have criticized the Hanging Paragraph and its judicial progeny defining the term PMSI. They recommended Congressional action to clarify the meaning of “PMSI” as used in the Hanging Paragraph. One commentator criticized the majority courts’ expanded definition of PMSI by relying on state law.

This article contributes to the discussion by pointing out the incongruence between the Hanging Paragraph rule and government’s role as envisioned by the basic economic theory. This article suggests that the Hanging Paragraph rule is inconsistent with government’s role as posited by the economic theory of externality and advocates for its elimination on that basis.

10 Rachel M. Helmers, Another Thorn In the “Semantic Briarpatch” of the Hanging Paragraph: Is Negative Equity a Purchase Money Security Interest? 93 MARQ. L. REV. 1217, 1242-43 (Spring 2010) (criticizing the majority decision to include the negative equity as part of the purchase money security interest as being incompatible with the fundamental policy of the Bankruptcy Code); Monica Griffith Braud, The Car Crunch: Did the “Hanging Paragraph” In BAPCPA Completely Eliminate the “Cram Down” Option for Many Chapter 13 Debtors?, 36 S.U. L. REV. 361, 382 (Spring 2009) (arguing against treating the negative equity as part of the purchase money security interest). Geoffrey M. Collins, Negative Equity and Purchase Money Security Interests under the Uniform Commercial Code and the BAPCPA, 95 CORNELL L. REV. 161, 189 (Nov. 2009). One commentator has also criticized the Hanging Paragraph with regard to the judicial treatment of deficiency upon debtors’ surrender of the vehicle within the Hanging Paragraph. Kang, supra note 6.

11 Helmers, supra note 10, at 1254-55.


13 The focus of this article is on the need to avoid encouraging negative externalities when government does choose to intervene in private transactions. For discussions of whether government should intervene to remedy negative externalities generated by predatory lending practices in subprime mortgage context and, by extension, to subprime auto financing transactions, please see the series of articles by Professors Engel and
To provide a context for discussion, Part II of this article outlines briefly the basic economic theory of externality and government’s role to remedy negative externalities. Part III demonstrates how the Hanging Paragraph rule and its judicial progeny run counter to the basic theory by creating enormous incentives for transactions that generate negative externalities. To understand the incentives at play, this article provides a brief description of the important role cars play in our society and auto sales and financing markets. The article then traces the creation of the Hanging Paragraph and its judicial progeny and their potential impact on the auto financing market. Part IV of this article identifies the negative externalities generated by excessive subprime auto financing transactions. This article concludes by advocating the elimination of the Hanging Paragraph rule.

II. The Economic Theory of Externality and Government’s Role to Remedy Negative Externalities.

When it comes to private transactions, U.S. law has generally taken a laissez faire attitude based on principle of freedom of contract. The economic theory of externality


answers the basic question of when government intervention in private transactions is necessary. The fundamental microeconomic principle is that competitive market equilibrium is the most efficient outcome. When market participants engage in transactions with each other, the transaction is considered efficient if it makes at least one party better off without making the other party worse off.

Negative externalities are present when one party’s action makes the other party or third parties worse off and the first party does not have to bear the cost. Negative externalities are considered harmful because it may provide incentives to engage in transactions because the party does not have to account for all the costs generated by the activity. This could result in oversupply of goods (if production is involved) or other inefficiency if the activity’s social costs exceed its benefit.

Because of the harm of negative externalities, the theory of externality posits that government intervention is potentially necessary when private transactions generate negative externalities. The application of the externality theory has generally focused on...
on transactions causing environmental pollution. A classic example of a private transaction with negative externalities is that of a steel plant located next to a river. The plant produces steel products and sludge waste as a byproduct of steel production. Absent any rules, the plant will dispose of the sludge by dumping it into the river. The sludge pollutes the river and kills many fish. As a result, the fishermen who are making a living by catching fish can no longer do so. The environmental pollution caused by the sludge dumping is a negative externality because it imposes a cost on fishermen that the steel plant does not have to bear – unless the government intervenes through environmental regulations.

In a series of articles, Professors Engel and McCoy applied the theory of externality to financing transactions that generate negative externalities. They pointed out that predatory subprime mortgage lending practices generate negative externalities because predatory mortgage lending practices affect not only borrowers, but the community in which borrowers live. Predatory lending leads to foreclosures, reduced property values, loss of city’s essential property tax revenues, abandoned homes. Because of

23 Id. note ___ at pp. 130-37.
24 Id. at p. 124.
25 Id. p. 146.
26 Engel & McCoy 2007, supra note 13 at p. 2042 (addressing the negative externalities associated with securitization of predatory lending in the subprime mortgage area). Engel, supra note 13 at p. 360 (addressing predatory lending in the mortgage area); Engel & McCoy 2002, supra note 13 at p. 1258 (arguing in favor of government intervention to deter predatory lending practices by imposing a duty of suitability on lenders.)
27 Engel & McCoy 2007, supra note 13 at p. 2042; Engel, supra note 13 at p. 360; Engel & McCoy 2002, supra note 13 at p. 1258.
28 Engel, supra note 13 at pp. 357-58
these negative externalities, they advocated for government intervention by imposing a duty of suitability on subprime lenders and brokers when they make loans. 29 They also identified another type of financial transactions, securitization of loans, as transactions that generate negative externalities because securitization fuels predatory lending practices that impose significant costs on cities. 30 Because of the negative externalities, they advocated for government invention by imposing assignee liability on brokers and lenders who engage in the financial transactions. 31

In sum, the basic economic theory of externality and existing applications anticipate government intervention to remedy negative externalities. If the government is to intervene at all, it should aim to deter negative externalities in order to restore market equilibrium. The Hanging Paragraph rule does exactly the opposite. The following sections explain how the Hanging Paragraph actually encourages transactions that generate negative externalities by examining the automobile market dynamics and the incentives generated by the bankruptcy rule and its progeny.

III. How the Hanging Paragraph Incentivizes Excessive Subprime Auto Financing Transactions.

The Hanging Paragraph prevents a Chapter 13 debtor from discharging a PMSI auto loan under certain conditions. 32 For a lender, non dischargeability of auto loans reduces

29 Engel & McCoy 2002, supra note 13 at p. 1258.

30 Engel & McCoy 2007, supra note 13 at p. 2042.

31 Id.

32 See supra note __ ; Moringiello, supra note 12 at pp. 969-70.
the incentive to monitor borrowers’ ability and/or willingness to pay.\textsuperscript{33} In the financing world, the risk of not being paid back the loan acts as a constraint on lending behavior and encourages the lenders to monitor the credit worthiness of the borrower out of self interest. Eliminating lending risks can motivate a lender to lend more easily, especially if lenders can enjoy big profits from lending.\textsuperscript{34} To understand the marketplace incentives, this section describes briefly the US auto sales and financing markets. Then, it will look at how the Hanging Paragraph and its progeny make it much easier to lend money, too easy in fact.

A. The Automobile Market: Sales and Financing

Unlike other consumer goods, cars have a special place in our society. Many people need them to earn a living.\textsuperscript{35} Cars are also intimately associated with the American identity – a symbol of the American individual freedom.\textsuperscript{36} As a result, there is a strong need for cars. As much as the Americans need to buy cars, the car sales industry also needs to sell cars.\textsuperscript{37} Car sales are directly related to the financial health of the car

\textsuperscript{33} Levitt & Dubner, supra note 9 at p. 16; Stiglitz, supra note 9 at pp.193-94, 271.

\textsuperscript{34} Stiglitz, supra note 9 at pp. 193-94.

\textsuperscript{35} Ken Bensinger, A Hard Road for the Poor in Need of Cars, LOS ANGELES TIMES, Nov. 3, 2011 (hereinafter “Bensinger No. 3”) (“No car, no work” is the conclusion reached by one of the interviewees, Lisa Twombly when she was told that she would be fired if she was late for work again).


\textsuperscript{37} Kang, supra note 6 at p. 51.
manufacturers, dealers, and their sales force. A major motivation is that car sales persons are paid by the quantity of cars they sell. 38

1. Strong Market Demand for Cars

Many Americans consider cars a practical necessity. 39 Research suggests that owning a car is related to families’ economic success. 40 In areas of the country with little or no public transit option, one needs a car in order to find and/or keep a job. 41 Even in areas with public transportation, cars are still necessary for many jobs. 42 Public transit rarely takes central city residents all the way to the suburban employers. 43 The job hours do not always match the commute needs of entry level workers who tend to work night or weekend shifts. 44 All of this means that in order to be economically successful in this country, one most likely will need a car.


39 Kang, supra note 6 at p. 51; Bensinger No. 3, supra note 35.


41 Bensinger No. 3, supra note 35.

42 Waller, supra note 40, at 2.

43 Id.

44 Id.
Americans also love their cars. We live in a nation with more cars than drivers. Cars, open roads, and freedom to go where one wants to go are intimately associated with the American values of freedom, individualism and the ability to control one’s destiny. Hence, Americans’ need for cars is both practical and psychological. The strong need for cars translates into strong market demand for cars.

2. The Financing of Car Purchases

For many people, a car is the second largest asset next to a home. Many purchase a car through financing. While most cars do not cost nearly as much as a home, few people can buy a car with cash. Majority of all vehicle purchases are financed through credit. Unlike the homes that people buy with financing and whose value may appreciate over time, a car purchased by a consumer invariably depreciates.

Car purchases are different from other consumer transactions. Buyers often have to pay more than the listed price. In a typical car purchase, a buyer pays taxes, title, and

45 Kang, supra note 6 at p. 51 and according to the updated Bureau of Transportation Statistics (“BTS”), a total of 250,272,812 vehicles were registered in the United States. See BureauofTransportationStatistics.com, Table 1-11: Number of U.S. Aircraft, Vehicles, Vessels, and Other Conveyances, http://www.bts.gov/publications/national_transportation_statistics/html/table_01_11.html (last visited Dec. 18, 2012).

46 Jeanes, supra note 36.

47 Id.

48 Id.

49 Kang, supra note 6 at p. 51-2.

50 Kang, supra note 6 at p.
other fees and charges related to the financing. Some may also purchase insurance or extended repair and replacement warranties. Some may need to pay off the negative equity on a trade in before they can make the next purchase.

Buyers can finance cars in different ways. Buyers with good credit can obtain a loan directly from a finance company, bank or credit union. A buyer agrees to pay the amount financed, plus an agreed-upon finance charge, over a period of time, and grants a security interest in the car to the lender. Once a buyer and a car dealer enter into a contract to purchase a vehicle, the buyer uses the loan proceeds from the direct lender to pay the dealership for the vehicle. Buyers with poor credit scores are unlikely to qualify for the conventional bank financing because banks have tightened the lending standards post subprime mortgage crisis.

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53 See examples in cases cited in *infra* note 82

54 Kang, *supra* note 6 at p. 84 n.229.

Another type of vehicle financing is dealership financing. A buyer and a dealership enter into a contract where the buyer agrees to pay the amount financed, plus an agreed-upon finance charge, over a period of time. The dealership may retain the contract, but usually sells it to an assignee (such as a bank, finance company or credit union), which services the account and collects the payments. In some cases, car dealers can also work with banks to provide financing and act like a broker between buyers/borrowers and lenders.

Dealers also offer manufacturer sponsored programs to buyers. The advantage of such a program is it allows dealers to sell more cars. The manufacturers’ primary objective is to sell cars. Manufacturers use their own financing arms, captives such as General Motors Acceptance Corp., Ford Motor Credit, and Toyota Motor Credit to

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57 Id.

58 Bensinger No. 1, supra note 55.


60 Id. (noting that “In recent years, automobile manufacturers have responded to overproduction by offering special rebate and financing offers to stimulate consumer demand.”)

61 The manufacturers’ primary goal is to reduce inventory. This goal is different from other direct bank lenders, whose primary goal is to earn a return for a limited amount of risk.
introduce special financing offers. These programs offer attractive financing terms and relaxed credit standards because they are designed to sell cars.

3. Incentives to loan money to facilitate a sale

Multiple parties involved in the car purchase transaction have incentives to loan money to buyers to facilitate a sale including paying off the negative equity. Direct bank lenders benefit because they can make money based on the financing charges. Car dealers are also motivated to push for car loans which cover both negative equity and the purchase price for the car. Making it easier for a buyer/borrower to use a trade in helps facilitate sale of a new car. Car dealers can profit both from the sale of cars plus the added benefit of profits from auto loans.

Car sales persons who work for car dealerships have strong incentives to sell loans. Their compensation generally depends on the loans they make and number of cars they sell. Naturally, the more loans they make, the more cars they can sell and the more money they can make. Car dealerships therefore are strongly motivated to push for car loans.

62 FDIC Supervisory Insights, supra note 59.

63 Kang, supra note 6 at pp. 51-2.

64 As the majority of the federal courts favoring treatment of negative equity as PMSI correctly pointed out, the lack of financing may discourage car sales. See, e.g. Howard, 597 F.3d at 858.

65 Confessions, supra note 52.

66 Sales Commission, supra note 38. Confessions, supra note 52.

67 Confessions, supra note 52.
B. The Hanging Paragraph and Its Judicial Progeny


The Hanging Paragraph became part of the bankruptcy law when Congress passed the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) in 2005.68 It significantly improves the auto financing industry’s position by making most of the PMSI auto loans non dischargeable in a Chapter 13 bankruptcy.69 BAPCPA is the result of over twenty years of “intense, fervent, and well-funded lobbying by the consumer credit industry.”70 As a result, some commentators suggested that the BAPCPA incorporated the “entire wish list” of the consumer credit industry.71

Michigan Senator Spencer Abraham introduced the Hanging Paragraph amendment at the request of the automobile finance industry.72 The Hanging Paragraph

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68 This article focuses on the Hanging Paragraph added to the Bankruptcy Code through BAPCPA. For a detailed discussion about all the other changes, please see generally, William C. Whitford, A History of the Automobile Lender Provisions of BAPCPA, 2007 U. ILL. L. REV. 143 (2007).

69 Stiglitz, supra note 9 at p. 194; Morigiello, supra note 12 at pp. 969-70. As an aside, the 2005 bankruptcy reforms also make it more difficult for an individual to file a Chapter 7 bankruptcy, essentially forcing many individuals into a Chapter 13 bankruptcy where they have to pay off the entire loan amount or give up the car. Rodriguez, supra note 7 at pp. 68-69.


71 Tabb, supra note 70, at 24. The 2005 bankruptcy reform effort is a good example of how concentrated economic resources can be used to engage in “rent seeking” behavior. Professor Ramirez pointed out that concentrated economic wealth reduces collective action costs and allows the industry to shape the law in its own favor. Steven A. Ramirez, LAWLESS CAPITALISM 37 (New York University Press 2013)

72 Whitford, supra note 68.
was justified as a response to alleged abuse by Chapter 13 debtors.\footnote{In re Payne, 347 B.R. 278, 281 (Bankr. S.D. Ohio 2006) (“[T]hrough the BAPCPA amendments to §1325(a)(5), Congress was attempting to remedy a perceived abuse by those who buy vehicles on credit on the eve of bankruptcy and then utilize the cramdown provisions of the Bankruptcy Code to pay the secured creditor a lesser amount than its full claim.”). Whether or not such perceived abuse exists is a question subject to challenge. See Hon. Keith M. Lundin, Ten Principles of BAPCPA: Not What Was Advertised, 24-SEP AM. BANKR. INST. J. 1 (Sept. 2005) (pointing out the consumer credit card industry’s campaign for public relations as Elizabeth Warren explained in her article, The Market for Data: The Changing Role of Social Sciences in Shaping the Law, 2002 WIS. L. REV. 1, 24-25 (2002)).} The concern was that certain debtors would load up on pre-petition debt such as a loan for a car only to file for bankruptcy shortly thereafter and have the debt crammed down to the value of the collateral under the pre 2005 bankruptcy law.\footnote{Id.}

Commentators have pointed out that prior to BAPCPA, professional organizations such as National Bankruptcy Conference or the National Conference of Bankruptcy Judges had influenced major congressional reforms of bankruptcy laws.\footnote{Whittford, supra note 68, at 190.} With regard to the 2005 bankruptcy reforms, the creditors’ groups dominated the discussions. The result favored the creditors.\footnote{Stiglitz, supra note 9 at p. 194.}

2. The Hanging Paragraph’s special treatment of PMSI secured creditors

The Hanging Paragraph makes a PMSI loan non dischargeable by excluding it from the cram-down provision of the Bankruptcy Code under certain conditions.\footnote{See, supra note 8.} In order for
a creditor’s claim to fall within the Hanging Paragraph, the creditor must satisfy the following requirements: (1) the creditor must have a PMSI in the collateral that secures the debt, (2) the debt is incurred within 910 days preceding the filing of the petition, (3) the collateral securing the debt must be a motor vehicle (or any other thing of value if it was incurred within one year preceding filing), and (4) the motor vehicle must have been acquired for the personal use of the debtor. If a creditor meets these requirements, the creditor’s claim will fall within the Hanging Paragraph and be treated as fully secured and non dischargeable under the Hanging Paragraph even if the value of the vehicle is significantly less than the loan.

3. The Judicial Progeny of the Hanging Paragraph – Treating Negative Equity as PMSI

To trigger the Hanging Paragraph, the creditor’s security interest has to qualify as a PMSI. What constitutes a PMSI becomes an important question. When Congress added the Hanging Paragraph to the Bankruptcy Code, it did not define the term PMSI. When car lenders lent money to pay off the negative equity on the trade in car and for the new car, car lenders argued in Chapter 13 bankruptcies that the portion of the loan used

78 This article focuses only on the impact of the Hanging Paragraph on the automobile market.

79 Id.

80 The term “purchase money security interest” is also used in 11 U.S.C.A § 522(f)(1)(B) and 11 U.S.C.A § 1110(d)(2). Dale, 582 F.3d 568, 573 (5th Cir. 2009) (“Because the Code does not define “purchase-money security interest” and that term does not have a common ordinary meaning…”).
to pay off the negative equity loan on buyers’ trade in also qualified as PMSI and could not be crammed down.\footnote{Moringiello, \textit{supra} note 12 at p. 972.}

After initial struggles interpreting the term, a clear majority of the Federal Circuit Courts now favor treating the negative equity as PMSI within the Hanging Paragraph.\footnote{In \textit{re Graupner}, 537 F.3d 1295 (11th Cir. 2008); In \textit{re Price}, 562 F.3d 618 (4th Cir. 2009); In \textit{re Ford}, 574 F.3d 1279 (10th Cir. 2009); In \textit{re Mierkowski}, 580 F.3d 740 (8th Cir. 2009); In \textit{re Dale}, 582 F. 3d 568 (5th Cir. 2009); In \textit{re Peaslee}, 585 F.3d 53 (2nd Cir. 2009), adopting the response to a certified question of the New York Court of Appeals, 13 N.Y.3d 75 (2009); \textit{Howard}, 597 F.3d 852; In \textit{re Westfall}, 599 F.3d 498 (6th Cir. 2010). For a comprehensive discussion of the circuit decisions up to 2009, see Collins, \textit{supra} note 10 at pp. 174-75. The single dissenting voice on this issue is the Ninth Circuit Court of Appeals in \textit{In re Penrod}, 611 F.3d 1158, 1161 (9th Cir. 2010), \textit{cert. denied} 2011 WL 4530304 (U.S. 2011). The First, Third and the D.C. Circuit Courts have not addressed the issue.

The decision dramatically expanded the scope of the Hanging Paragraph. The majority of the circuit courts held that the negative equity formed part of the price of the collateral and therefore, should be treated as a PMSI within the Hanging Paragraph.\footnote{I am only providing a brief summary of the judicial decisions here. For a detailed discussion of the case law on this issue, please see Helmers, \textit{supra} note 10. \textit{See also cases cited in supra} note 82; Moringiello, \textit{supra} note 12.}

These courts relied on various rationale to support their interpretation. Most of them looked at Comment 3 to Article 9-103 and concluded that the drafters intended the list to be construed broadly.\footnote{Comment 3 of Article 9-103 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.” UCC 9-103, cmt. 3. \textit{See Price}, 562 F.3d at 626.}
Some courts adopting the majority position reasoned that there was a “close nexus between the acquisition of collateral and the secured obligation” because the financing of negative equity is an integral part of the sale of a new car. Some found that under a natural reading of state law, the negative equity financing here created a purchase-money obligation because that financing “enabled” the buyers to acquire rights in their new car. The Fourth Circuit found this interpretation of the statute coincided with Congress' intent in enacting the Hanging Paragraph: to protect secured car lenders from having their claims bifurcated in Chapter 13.

The Seventh Circuit also joined the majority position uncritically. Judge Posner explained the rationale for the court’s conclusion based on the automobile industry’s need to sell cars. The Court explained the negative equity financing is often necessary to enable the purchase of the car and noted that the Chapter 13 cram down provision would discourage the lenders to provide the negative equity loan.

The Ninth Circuit is the only dissenting voice on this issue. The Ninth Circuit, and those holding the dissenting views, found that packaging negative equity with

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85 See, e.g. Peaslee, 585 F.3d at 57; Price, 562 F.3d at 625 (“Under a natural reading of state law, the negative equity financing here created a purchase money obligation because that financing enabled the Prices to acquire rights in their new car.”); Dale, 582 F.3d at 575 (finding that the extension of new credit to pay off the negative equity on the trade in vehicle enabled the debtor to purchase the new vehicle).

86 Dale, 582 F.3d at 575.

87 Price, 562 F.3d at 628.

88 Howard, 597 F.3d at 858 (noting that treating the negative equity as PMSI may be “may be essential to the flourishing of the important market that consists of the sale of cars on credit”).

89 In re Penrod, 611 F. 3d 1158, 1162 (9th Cir. 2010).
purchase money was actually a refinancing of an antecedent debt.\footnote{Id.; Mierkowski, 580 F.3d at 746 (Bye, J., dissenting) ("Negative equity is an antecedent unsecured debt and cannot be transformed into a purchase money obligation secured by a PMSI by rolling it into the loan used to finance the actual price and costs directly related to purchasing the vehicle."); Matter of Peaslee, 13 N.Y.3d 75, 83 (N.Y. Ct. App. 2009) (Smith, J., dissenting) ("A refinanced loan is not, in accounting terms, properly speaking an ‘expense’ at all; it is the substitution of a new liability for an old one.").} The Ninth Circuit noted that in reality there were two transactions: the extinguishment of an obligation on the old car and funds given to acquire rights in the new car. The Ninth Circuit concluded that negative equity did not represent any part of the price or costs arising from the sale.\footnote{Mierkowski, 580 F. 3d at 746 (Bye, J., dissenting).} The Ninth Circuit pointed out that, although a buyer might need the negative equity loan in order to buy a car, the focus should be on the requirements set out in Article 9, “not what is necessary to entice sellers and lenders into the transaction.”\footnote{Id.}

Neither the majority nor the minority decisions discussed the potential adverse incentives that the negative equity decision might create with regard to the lending behavior in the market place. Nor did the courts pay attention to the negative externalities that the transactions may generate on the society as a whole. As explained below, the majority decision significantly expands the scope of the Hanging Paragraph and creates even more incentives for irresponsible lending.\footnote{The U.S. Supreme Court has denied a writ of certiorari to resolve the circuit conflict on this issue. American Credit Financial Services, Inc. v. Penrod, 132 S.Ct. 108 (Oct. 2011).}
4. The Significance of the Hanging Paragraph and Its Progeny.

The Hanging Paragraph is significant for auto lenders because it dramatically improves their position in a Chapter 13 bankruptcy. In the motor vehicle context, the value of an automobile rapidly depreciates once it is driven off the lot.\(^\text{94}\) Therefore, auto lenders typically have claims that are larger than the value of the collateral. The disparity between the creditor’s claim and the value of the collateral is even greater if the creditor provides additional negative equity loan.\(^\text{95}\)

Prior to the Hanging Paragraph, when individual debtors filed for bankruptcy under Chapter 13 while owing money on cars, debtors could use the cram-down provision of Section 506 to bifurcate lenders’ claims into secured and unsecured claims.\(^\text{96}\) Car lenders would be forced to take a secured claim in the market value of the cars and an unsecured claim in the rest.\(^\text{97}\)

The Hanging Paragraph has changed that. Car lenders can rely on the Hanging Paragraph to have the entire loan amount treated as fully secured.\(^\text{98}\) Because of that, for individual debtors to successfully emerge from the Chapter 13 bankruptcy, they would

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\(^{94}\) Kang, supra note 6 at p. 53.

\(^{95}\) Moringiello, supra note 12 at p. 971.

\(^{96}\) 11 U.S.C.A. § 506(a)(1) (2012). Section 506(a) of the Bankruptcy Code states: “An allowed claim of a creditor secured by a lien on property in which the estate has an interest...is a secured claim to the extent of the value of such creditor’s interest in the estate’s interest in such property...and is an unsecured claim to the extent that the value of such creditor’s interest...is less than the amount of such allowed claim.”

\(^{97}\) Moringiello, supra note 12 at 968.

\(^{98}\) See cases cited in supra note 82.
have to pay for the entire loan or surrender the car to the creditor.\footnote{Kang, \textit{supra} note 6 at p. 50.} Surrendering the car is often not an option if a debtor needs the car to earn a living.\footnote{Bensinger No. 3, \textit{supra} note 35.}

\section*{5. The Hanging Paragraph and Incentives for Excessive Lending}

The Hanging Paragraph and its progeny create enormous incentives for irresponsible auto financing lending. The Hanging Paragraph has the most impact on the subprime financing industry.\footnote{Subprime borrowers are borrowers with a credit score of 550 and below. Melinda Zabritski, \textit{Experian, State of the Automotive Finance Market Fourth Quarter 2012}, http://www.experian.com/assets/automotive/white-papers/2012-q4-state-of-automotive-financing.pdf (last visited on March 19, 2013) (hereinafter referred to as “Experian Q4 2012 Report”). The Hanging Paragraph affects the subprime car buyers more than the buyers who have good credit. Those buyers with good credit have more banking options and can get much better financing deals under the current low interest rate environment.} On the buyers’ side, there is a strong demand for cars. There are buyers who need cars and who do not have other credit options because of their poor credit scores.\footnote{The number of subprime borrowers rose substantially due to the subprime mortgage crisis when millions of people lost their jobs and struggled financially to make ends meet.} On the sellers’ side, the car dealers have strong built in incentives to sell cars. Car sales persons often get compensated by the number of cars they sell.\footnote{Sales Commission, \textit{supra} note 38.} Since loans will enable the sales persons to sell cars, they will be motivated to lend money so that they can sell cars.\footnote{\textit{Howard}, 597 F.3d at 858.}

With the Hanging Paragraph and the majority judicial decision, selling cars has become much easier. The car dealers and lenders can offer to pay off the negative equity
more readily because they will most likely to be paid regardless of the credit worthiness of the buyer. Enticing the buyers also gets easier because auto lenders can now pay off the loan on the trade in.  

6. **Troubling signs on the horizon**

The strong demand for cars and incentives to sell cars create a market place ripe for excessive greed. The Hanging Paragraph, as expanded by the majority decision, essentially removes all the lending risks for the lenders. The Hanging Paragraph can only fuel excessive lending in this area. Recent trends in the auto financing industry show that subprime auto financing industry is growing rapidly. More and more subprime buyers are qualifying for the loans despite their poor credit scores. Subprime loan approvals for buyers with less than stellar credit came in at 62.5

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106 Stiglitz, *supra* note 9 at pp. 193, 271 (noting that non dischargeability or difficulty to discharge in a bankruptcy encourages bad lending and lenders have more incentive to engage in predatory lending.)

107 Although it is difficult to establish a causal link between market trends and rules, rules do shape markets as market participants respond to incentives. As Hacker and Pierson pointed out, although it is difficult to know exactly what the effects of certain rules are, they do matter. Hacker & Pierson, *supra* note 1 at p. 44. Indeed, no one seemed to know what the consequences of two decades of financial deregulation were until after the fact as we looked backwards on what happened *Id.* at pp. 69-70. As Johnston noted, the changes in the market place tend to take place over time and the big picture tends to be missed when events are reported as discrete or unnoticed. Johnston, *supra* note __ at p. 31.
percent increase in September 2012 over September 2011 while October 2012 saw year over year increase of 50 percent.\(^{108}\)

Subprime borrowers are borrowing a lot more than the value of cars purchased when they finance car purchases. Most recent data shows that the loan amount on the used cars are as much as 52 percent more than the value of the cars.\(^{109}\) For the people with impaired credit ratings (subprime and below), the loan to value ratio for used cars is 142 percent to 152 percent while for the new cars ranges from 125.6 to 125.9 percent.\(^{110}\) Subprime borrowers are more likely to finance the purchase of used cars.\(^{111}\) For a subprime borrower most likely to be impacted by the Hanging Paragraph, they are borrowing close to 52 percent more than the value of the car purchased before they even drive the car off the lot. The increased loan to value ratio means that a lot of cars are under secured.

Borrowers are taking longer and longer to pay off car loans. To compensate for the larger loan balances, loan amortization periods have lengthened to keep monthly payments low and vehicles seemingly more affordable. For those with impaired credit rating (subprime and below), the average loan term for new cars is up to 70 months while for the used cars is up to 60 months as of the fourth quarter of 2012.\(^{112}\)

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\(^{109}\) Experian Q4 2012 Report, *supra* note 101 at p.32.

\(^{110}\) *Id.* at p. 33.

\(^{111}\) *Id.* at p. 23.

\(^{112}\) *Id.* at p. 35.
subprime borrowers on average almost six years to pay off a car. The longer the loan
term it is, the more difficult it is to accumulate any equity in the car, and the more likely
it is for a consumer to have negative equity when they trade in their car for a new one.
Based on the above financing trends, more and more borrowers will be borrowing
additional money to pay off the negative equity on their trade ins. 113

Because of the profit potential, a growing group of car dealers have been focusing on
aggressively lending and selling to subprime borrowers. 114 These dealers are known as
Buy-Here-Pay-Here dealers (“BHPH dealers”). They have been engaging in aggressive
sales pitches to entice consumers. 115 Some dealers promised buyers that “they will pay
off the balance of your loan – no matter how much you owe.” 116

The BHPH dealers target people who need cars to get to work, but can’t qualify for
conventional loans because of poor credit scores. 117 Because the buyers can’t obtain
loans elsewhere, they have to pay interest at three times or more than the going rate for
regular used car loans. 118 The BHPH dealers make an average profit of 38% on each

113 Morigiello, supra note 12 at pp. 970-71.
114 Ken Bensinger, Investors place big bets on Buy Here Pay Here used-car Dealers, LOS
here/la-fi-buyhere-day-two-2011 (last visited Oct. 19, 2012) (hereinafter as
“Bensinger No.2”) (noting that BHPH dealers courts people on the financial edge.)

115 The dealers’ aggressive sales pitches have attracted the attention of the Federal Trade
Commission (“FTC”). In March, 2012, the FTC issued a consumer alert on negative
equity and auto trade-ins. See FTC Consumer Alert, supra note 105.
116 Id.
117 Bensinger No. 2, supra note 56.
118 Id. (noting that the BHPH are “. . . lenders of last resort, they can charge interest rates
at three times or more the going rate for regular used car loans.”)
Buyers’ default outside of bankruptcy does not matter. The dealers simply repossess the cars and in many cases sell them again, a practice called churning.\footnote{Id. (quoting the National Alliance of BHPH Dealers that the dealerships make an average profit of 38 percent, more than double the profit margin of conventional retail car chains.)} If borrowers do file for bankruptcy, the Hanging Paragraph makes it non dischargeable in a Chapter 13 bankruptcy in most cases.\footnote{Bensinger No.1, supra note 55 (describing a practice called churning – repeated sales of the same car, noting that certain dealers have resold hundreds of cars multiple times and in one dealership in Kansas City, four cars have been sold eight times a piece.)} According to a Los Angles Times article, hundreds of cars have been sold multiple times by the used car dealers.\footnote{The 2005 bankruptcy reforms also make it more difficult for an individual to file a Chapter 7 bankruptcy, essentially forcing many individuals into a Chapter 13 bankruptcy where they have to pay off the entire loan amount or give up the car. Rodriguez, supra note 7 at pp. 68-69.} BHPH dealers and credit unions showed the strongest market share growth of all lenders during the 4\textsuperscript{th} quarter of 2012.\footnote{Bensinger No. 1, supra note 55.}

910 days of the car purchase, the borrower can no longer use the cram-down provision to reduce the loan to the actual market value of the car. Under the judicial expansion of the Hanging Paragraph, a Chapter 13 debtor cannot cram down the loan even though a portion of the loan includes the negative equity on a different car. A Chapter 13 debtor would have to either pay the entire amount of the loan or surrender the car. Under either scenario, the BHPH dealers have a comfortable profit margin, or “the gift that keeps giving.”

The high profit of the subprime auto financing industry is attracting more and more investors’ money. These subprime auto loans are being bundled together and sold as

\[\text{References}\]

125 See discussions in Section __.

126 Id.

127 Id. See also Bensinger No. 2, supra note 56 for an example where the debtors who bought a truck from a BHPH dealer and had to pay for the car despite their bankruptcy filing because they were not willing to give up the truck).

128 Bensinger No. 2, supra note 56 (quoting Michael Diaz, a national sales manager for Small Dealers’ Assistance, Inc. in Atlanta, which buys loans from BHPH dealers, “The amount of return from these loans you can’t get on Wall Street. You can’t get it anywhere. . . It is the gift that keeps giving.”).

129 Moody’s Investors Service: Hot US subprime auto lending market has parallels to the 1990s (June 28, 2012), http://www.mdyos.com/researchdocumentcontentpage.aspx?docid=PBS SF290230 (last visited on December 19, 2012) (hereinafter “Moody’s Report”) (stating that “[t]he subprime auto lending market in the US is developing a resemblance to its condition in the early-and mid-1990s when overheated competition among lenders led to poor underwriting that drove up losses. . . capital is pouring into the sector and the issuance of subprime auto asset-backed securities (ABS) is booming.”) Bensinger No. 2, supra note 56 (noting that “private equity firms are investing in chains of used car lots and auto loans are being packaged into securities much like subprime mortgages. They are attracted by the industry’s average profit of 38 percent for each car sold”).
investment grade securities. Some financing companies buy up the subprime auto loans from different dealers which are happy to trade future revenue streams for cash upfront. They then combine the loans into securities and sell them to investors. The securitization passes the default risks to these investors. Some BHPH dealers securitize their loan portfolios themselves. Subprime auto loan issues now represent a higher percent of all auto-loan securitizations since 2006.

According to Moody’s Investor Service (hereinafter Moody’s), the credit quality of auto loans securitized in 2011 and 2012 has loosened since 2010. Moody’s noted the increasing demand for subprime auto loan securitization products and cautioned that it may lead to a deterioration of the underwriting standards for the auto loans. The Los Angeles Times reported that the BHPH dealerships are issuing car loans to consumers who have bad credit and then packaging the loans and selling them to investors in secondary financial markets.

130 Bensinger No. 2, supra note 56 (noting that most of these bonds have been rated investment grade. Many have received the highest rating: AAA.”)

131 Id. (noting that “dealers proved eager to trade future revenue streams for cash upfront.”)

132 Engel & McCoy 2007, supra note 13 at 2040-41

133 Bensinger No.2, supra note __.

134 Id.

135 Moody’s Report, supra note __.

136 Id.

137 Bensinger No. 2, supra note 56.
Furthermore, there is very little regulation in place to supervise the car dealers.\textsuperscript{138} Auto industry lobbyists have successfully lobbied to have auto dealers excluded from the most recent Dodd-Frank Act intended to prevent another subprime mortgage lending crisis.\textsuperscript{139} Auto dealers are excluded from the scope of Consumer Financial Protection Bureau’s authority if they are predominantly engaged in the sale and servicing of motor vehicles and routinely assign the installment contract to an unaffiliated third-party finance or leasing source.\textsuperscript{140} According to one estimate, this exclusion applies to most of the auto dealers who sell cars on credit and then assign the resulting installment payment contracts to an unaffiliated third-party financing source.\textsuperscript{141} The exclusion thus applies to many BHPH dealers discussed earlier.\textsuperscript{142}

Signs of abusive practices are appearing on the market place. Subprime auto lenders have been charging consumers hidden fees, lying about interest rates, and inaccurate

\textsuperscript{138}California is the first state, and as of this date, the only state which has enacted some law regulating the BHPH dealers. The law imposes some disclosure and warranty requirements by BHPH dealers. The law, however, does not impose any cap on the interest rates charged, a grace period on repossessions and a requirement that dealers register with the Department of Corporations as lenders. Ken Bensinger, \textit{Dealers: New Buy Here Pay Here Laws Could Have Been Worse}, LOS ANGELES TIMES, Oct. 1, 2012, \url{http://articles.latimes.com/2012/oct/01/business/la-fi-mo-dealers-react-bphh-laws-20121001} (last visited Feb. 20, 2013).

\textsuperscript{139}Barkley Clark and Barbara Clark, \textit{Historic Wall Street Reform and Consumer Protection Act Changes the Banking Industry}, 19 CLARKS’ BANK DEPOSITS AND PAYMENTS MONTHLY 9 (July 2010).

\textsuperscript{140}\textit{Id.}

\textsuperscript{141}\textit{Id.}

\textsuperscript{142}It is not difficult to see that the availability of this exclusion will likely motivate the dealers to structure their business models in a way to escape the regulatory authority of the CFSC.
reporting of facts on borrowers’ loan applications.\textsuperscript{143} The packages of pooled car loans sold to financial institutions are backed by contracts signed by borrowers who cannot even qualify for a credit card.\textsuperscript{144}

With securitization and the demand for car loans to be bundled up, this segment will increase in the future.\textsuperscript{145} Because securitization further removes the risk, it will provide even more incentives for aggressive lending.\textsuperscript{146} Thus, a vicious cycle of aggressive lending without any constraints is created.\textsuperscript{147}

\section*{IV. Negative Externalities and Excessive Subprime Auto Financing Transactions}

The Hanging Paragraph and its judicial progeny have now set the stage for rampant excessive subprime lending by auto lenders. The Hanging Paragraph has removed lending risks from subprime auto financing transactions. The judicial negative equity decision gave the lenders additional sales tools to induce borrowers to enter into loans. The emerging securitization in the subprime auto loan context further eliminates any risks.

Faced with unrelenting onslaught of available credit and promises, many borrowers will likely incur excessive debt. Many scholars have pointed out that

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{143} Bensinger No. 2, \textit{supra} note 56.
\item \textsuperscript{144} \textit{Id}.
\item \textsuperscript{145} \textit{Id}. (noting that the BHPH dealers are using the money from investors to expand their businesses).
\item \textsuperscript{146} Engel & McCoy 2007, \textit{supra} note 13 at 2041.
\item \textsuperscript{147} Bensinger No.2, \textit{supra} note \_\_\_\_.
\end{enumerate}
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excessive debt does not merely affect the individual. Rather, it imposes numerous negative externalities on the society as a whole.\textsuperscript{148} These kind of transactions should be discouraged, not encouraged as the Hanging Paragraph is apt to do.

A. Excessive subprime auto financing, a déjà vu of subprime mortgage crisis?

Incentives to profit, removal of lending risks, easy availability of investor money, and lack of regulatory constraints are the factors that incentivized subprime mortgage lending practices leading to a unprecedented global financing crisis.\textsuperscript{149} As shown above, all those factors are present in subprime auto financing industry. Excessive subprime auto financing practices can pose serious risks to our economic future.\textsuperscript{150}

The auto financing industry has many built in incentives to loan money and to sell cars because the compensation of the parties involved is directly tied to the quantity of the loans and cars sold.\textsuperscript{151} Removal of lending risks by the Hanging Paragraph and its judicial progeny adds further fuel to existing incentives to sell loans and cars. Without

\textsuperscript{148} Katherine Porter, \textit{The Damage of Debt}, WASH. \& LEE. L. REV. 979, 987, 990, 998-99 (Spring 2012).


\textsuperscript{151} See Sales Commission, \textit{supra} note 38; Confessions, \textit{supra} note 52.
any lending risks, car lenders/sellers are motivated to give out more loans in order to sell more cars.\textsuperscript{152}

Auto lenders/dealers now also have easy access to investor money because of securitization.\textsuperscript{153} Subprime auto loan securitization has been increasingly popular.\textsuperscript{154} Subprime auto loans have been steadily rising since the 2008 financial crisis.\textsuperscript{155} The high profitability will generate high demand for the financial products which will in turn generate more subprime lending.

The same factors in the subprime mortgage lending context led to excessive subprime lending which triggered a global financial crisis. During the heyday of subprime mortgage lending, the lenders had strong incentives to push the loans to the subprime borrowers because lenders, brokers and banking employees involved in the subprime mortgage chain were paid based on the quantity of loans generated instead of the quality.\textsuperscript{156} The incentive of immediate profit motivated those participants to push loans unto borrowers regardless of their credit risks.\textsuperscript{157}

\begin{footnotesize}
\begin{enumerate}
\item Stiglitz, \textit{supra} note 9 at pp. 193, 271.
\item Bensinger No.2, \textit{supra} note __.
\item \textit{Id.}
\item Experian Report Q4 2012 Press Release, \textit{supra} note 123.
\item FCIC Report, \textit{supra} note 49 at p. 64, 145-46 (quoting Patricia Lindsay of New Century Financial, a subprime mortgage lender that had failed as a result of the financial crisis, “The originators, the loan officers, account executives, basically the salespeople [who] were the reason our loans came in . . . were compensated very well,” . . . And volume mattered more than quality. She noted, “Wall Street was very hungry for our product. We had our loans sold three months in advance, before they were even made at one point.”); L. Randall Wray, \textit{Lessons from the subprime meltdown}, Working papers // The Levy Economics Institute, No. 522 (2007), http://hdl.handle.net/10419/31658, pp.8-9 (pointing out that “[a]s originators would not hold the mortgages, there was little reason to worry about ability to pay. Indeed, since banks, thrifts, and mortgage brokers
Securitization provided the subprime mortgage lenders more access to investment money and passed the default risks to third party investors.\textsuperscript{158} The subprime mortgage crisis starkly demonstrates that removal of the lending risks can affect people’s behavior. The Financial Crisis Inquiry Commission concluded that the financial crisis was caused because “no one in this pipeline of toxic mortgages had enough skin in the game. They all believed they could off-load their risks on a moment’s notice to the next person in line.”\textsuperscript{159}

Lack of regulation or decades of deregulation in the subprime mortgage context also led to excessive lending. Wall Street, just like the auto financing industry (the banks have about 41 percent of the auto loan share)\textsuperscript{160} had systematically lobbied against any government regulations over the financing industry for years.\textsuperscript{161} As a result, there was little government oversight on the mortgage financing industry.

\textsuperscript{157} Id.

\textsuperscript{158} Engel & McCoy 2007, supra note 13 at p. 2041-42.


\textsuperscript{160} Experian Q4 2012 Report, supra note 101 at p. 26.

\textsuperscript{161} FCIC Report, supra note 49 at p. xviii (concluding that “[t]he sentries were not at their posts, in no small part due to the widely accepted faith in the self correcting nature of the markets and the ability of financial institutions to effectively police themselves. More than 30 years of deregulation and reliance on self-regulation by financial institutions, championed by former Federal Reserve chairman Alan Greenspan and others, supported by successive administrations and Congresses, and actively pushed by the powerful financial industry at every turn, had stripped away key safeguards, which could have helped avoid catastrophe.”)
The lessons of subprime mortgage crisis are still fresh. The multiple factors which led to excessive subprime mortgage lending are also present in subprime auto financing industry. Because the Hanging Paragraph and its progeny excessively encourage subprime auto financing, Congress should eliminate the Hanging Paragraph to remove those incentives and put lending risks back on lenders/dealers.

B. Excessive debt deters individual participation in economy and cast a pall over economy at large.

Many scholars have recognized that excessive indebtedness harms not only the indebted individual, but also society as a whole. Borrowers’ excessive debt load


\[163\] Porter, supra note 148, at pp. 987, 990, 997-98 (noting that the harms of debt may extend from the debtor to the larger society and criticizing the current research on harm for failing to assess the actual problem to be solved – the externalities and costs of debt, and lack of any empirical findings to identify the consequences of excessive debt.) Some researchers have attempted to quantify the cost associated with predatory lending in the mortgage area. Eric Stein, Quantifying the Cost of Predatory Lending, http://www.responsiblelending.org/mortgage-lending/research-analysis/the-economic-cost-of-predatory-lending-2001.PDF (last visited March 17, 2013). So far, economists have attempted to quantify the cost of negative externalities by using financial metrics, but financial metrics cannot measure the non financial harms of overindebtedness. Porter, supra note 148, at pp. 982-83. Many costs imposed by excessive subprime auto financing are intangible and often caused by multiple factors. How does one put a dollar amount on one’s inability to achieve full economic potential, mental stress, reduced sense of wellbeing, reduced quality of life, the reduced opportunity for upward mobility, loss of trust in the system? Should the intangible costs matter? Id. at 1000-01. Those questions are beyond the scope of this article. Although the impact of excessive debt load on the society is hard to quantify, one can hardly deny its existence.
affects their ability to participate in economic life productively. Debt burdened individuals might avoid entrepreneurial employment.\textsuperscript{164}

Debt burdened individuals without any way out will not be able to reach their full economic potential. As Professor Steven Ramirez pointed out, economic oppression preventing individuals from reaching their full economic potential deters market development and innovation.\textsuperscript{165} Their inability to participate economically threatens the stability of their own financial health and affects the community in which they live.\textsuperscript{166} It also affects the upward mobility of their children because debtors’ children school education could also be affected by the financial stress induced by excessive debt.\textsuperscript{167} Financial stress could also damage the debtor’s family relationships.\textsuperscript{168} All of these are costs to the society at large as a result of excessive debt load.

The subprime auto lending practices, if unchecked, will have lasting and insidious damage to our economy. As long as the Hanging Paragraph prevents the debtors from discharging the auto loans, the auto loan business model can conceivably perpetuate itself because of the continuous demand for cars by people with the fewest options. Having to incur higher cost for automobile financing, the borrowers will have to allocate their limited financial resources to pay off the car loan above all other obligations such as food

\textsuperscript{164} Porter, \textit{supra} note 148, at p. 1015.

\textsuperscript{165} Ramirez, \textit{supra} note 71, at p. 131.

\textsuperscript{166} Engel & McCoy 2007, \textit{supra} note 13 at p. 2042.

\textsuperscript{167} Porter, \textit{supra} note 148, at 1015, 1021

\textsuperscript{168} \textit{Id.} at pp. 1020-21.
on the table and investment into their children’s education.\textsuperscript{169} Because the money has to be used to pay off car loans, they have to lower their consumption which will affect the economic health of the society as a whole.\textsuperscript{170}

C. Excessive subprime auto financing transactions contribute to the growing wealth disparity in this country.

Economists have sounded alarm regarding rapidly increasing wealth inequality in this country.\textsuperscript{171} The wealth gap has been growing at an alarming rate for the past thirty years.\textsuperscript{172} How do we get here? Some scholars have identified government rules and policy that have shaped the distribution of income.\textsuperscript{173}

The Hanging Paragraph is an example of those rules that favor those with more resources.\textsuperscript{174} The Hanging Paragraph encourages subprime auto lending which targets

\begin{footnotesize}
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\item \textsuperscript{169} Stiglitz, \textit{supra} note 9 at p. 95.
\item \textsuperscript{170} \textit{Id.} at p. 85 (explaining how moving money from the poor people to the higher income population lowers consumption.
\item \textsuperscript{171} \textit{Id.} at pp. 4-5, 118-19.
\item \textsuperscript{172} \textit{Id.} at p. 4; Ramirez, \textit{supra} note 71 at p. 36.
\item \textsuperscript{173} Stiglitz, \textit{supra} note 9 at pp. 28-33 (pointing out that “[m]uch of the inequity that exists today is a result of government policy, both what the government does and what it does not do.” ) Hacker & Pierson, \textit{supra} note 1 at p. 44 (noting that “[t]he rules of the market make a huge difference for people’s lives. And what matters is not the broad label applied to what government does … but the underlying details that most commentators blithely ignore.”)
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the groups that can least afford to pay the high interest rates – those who do not have 
good credit to take advantage of the lower interest rates available to those who have more 
resources. The Hanging Paragraph will have little impact on people who are financially 
well off. The poorest, however, will be forced to incur excessive debt in order to buy a 
car. The Hanging Paragraph essentially diverts money into the pockets of the auto 
lenders/dealers from society at large.\textsuperscript{175}

When the borrowers are in dire financial straits and file for bankruptcy under 
Chapter 13, debtors cannot discharge their excessive debt load under the Hanging 
Paragraph.\textsuperscript{176} Being forced to pay off the loan will only add additional stress to the 
debtors and increases the chance that the debtors will spiral further downward financially. 
This downward spiral creates a vicious cycle of poverty which ensures that the society 
has a perpetual economic underclass.\textsuperscript{177}

The growing disparity is a negative externality imposed by excessive subprime 
auto financing transactions. As Stiglitz pointed out, societies with extreme inequality 
cannot function efficiently.\textsuperscript{178} When one group has too much resources and political 
clout, it will try to advocate for policies that benefit itself.\textsuperscript{179} With the ability to

\textsuperscript{175} Stiglitz, supra note 9 at p. 83.

\textsuperscript{176} See discussions in Section III(B)(4).

\textsuperscript{177} What contributes to the unprecedented wealth disparity is multifaceted and many rules 
and decisions contribute to that over the past few decades. Eliminating the Hanging 
Paragraph rule is one step in the right direction.

\textsuperscript{178} Stiglitz, supra note 9 at pp. 83-84

\textsuperscript{179} Id. at p. 83; Ramirez, supra note 71 at p. 37.
manipulate government policy in its favor, the rich will get richer and the poor will get poorer, unless something changes.

D. Social tolerance of subprime lending practices contributes to the erosion of fundamental values of our society.

The Hanging Paragraph creates incentives for transactions which contribute to the erosion of our sense of fair play, one of our fundamental values. It provides incentives for auto lenders to exploit people who have few options and who are financially unsophisticated. As Stiglitz observed, people who engaged in predatory subprime mortgage lending practices and who targeted the poorest and the least educated among us should have felt guilty. He was struck by the lack of remorse.

One of the justifications for subprime mortgage lenders is that the borrowers chose to enter into these transactions and it was the borrowers’ financial irresponsibility that got them into excessive debt. This attitude ignores the fact that lenders are the ones with more information and more resources to manipulate the market place. It also

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180 Ramirez, supra note 71 at 37-38.
181 Stiglitz, supra note 9 at p. xvii.
182 Id.
183 Id.
185 Oren Bar-Gill, The Behavioral Economics of Consumer Contracts, 92 MINN. L. REV. 749(2007-2008) (pointing out that in certain markets such as consumer financing, consumers often make mistakes because of imperfect information, imperfect rationality.); See also, Confessions, supra note 52 (expressing amazement at the mistakes that car buyers made during transactions at car dealerships.)
fails to acknowledge that the borrowers are the least financially sophisticated. 186 The subprime borrowers often do not have any other financing options and they are more likely to fall prey to predatory tactics because they have few options. 187 The lenders are in a better position to avoid excess that harms not only the borrowers, but also our society at large. 188

Another justification of subprime lending is that the subprime lenders serve people who otherwise would have no access to credit because lenders who provide credit to people with good credit do not really want to do business with the subprime borrowers. 189 This response does not take into consideration that there may be other ways to improve access to credit which may not involve exploitation of the poor, the desperate and/or unsophisticated. 190

186 Stiglitz, supra note 9 at p. 191.

187 Bensinger No. 1, supra note 55.

188 See also Stiglitz, supra note 9 at p. 271 (suggesting that “the lender should bear the brunt of the consequences of a mistake, not the borrower” where there is information and bargaining power asymmetry.) Engel & McCoy 2002, supra note 13 at p. 1258 (putting the cost on the lenders best able to bear the loss).

189 Bensinger No. 3, supra note 35 (describing dealers as saying that “they are meeting a societal need and not just squeezing profits from people who are down on their luck.”)

190 It is beyond the scope of this paper to examine the ways that access to credit can be increased without exploitative behavior. For example, the government can provide tax incentives for companies to provide access to credit. The government can also provide tax incentives for parties to provide financial literacy training. See discussions in Stiglitz, supra note 9 at pp. 265-90 on suggestions for a better world. See also Bensinger No. 3, supra note 35 (describing a low-income car ownership program called Good News Mountaineer Garage, which sold the interviewee a car in good condition for $1).
Conclusion

The basic economic theory of externality posits that when the government chooses to intervene, its goal is to remedy negative externalities, not to encourage them. The Hanging Paragraph rule and its progeny have exactly the opposite effect. The Hanging Paragraph encourages negative externalities by distorting market place incentives to engage in excessive subprime auto financing transactions. The rule as interpreted by the federal courts have removed most lending risks from subprime auto financing transactions by making most auto loans non dischargeable in a Chapter 13 individual bankruptcy. With enormous incentives to profit, easy availability of investor money, and little government oversight, auto lenders will engage in excessive subprime auto financing transactions. The same confluence of factors led to excessive subprime mortgage lending practices with devastating consequences on our economy.

Excessive subprime auto financing leads to over indebtedness by subprime borrowers. Overwhelming debt burden without any ability to discharge the auto loans makes it difficult for borrowers to climb out of the poverty trap. Many scholars have warned that keeping a large segment of the population in economic oppression will exact a toll on our economy.\footnote{Stiglitz, supra note 9 at pp. 83-84; Ramirez, supra note 71 at p. 34; Hacker & Pierson, supra note 1 at p.4.} Therefore, these negative externalities support Congressional elimination of the Hanging Paragraph rule.