

# ALLOWING DUAL STATUS FOR PURCHASE-MONEY SECURITY INTERESTS IN CONSUMER-GOODS TRANSACTIONS

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## I. INTRODUCTION

A common event in the life of a purchase-money security interest in consumer goods<sup>1</sup> is the agreement between the secured party and debtor to refinance<sup>2</sup> or renew<sup>3</sup> the debt when the debtor is unable to pay completely on the date the debt is due. The refinancing or renewal of the debt raises the issue of whether the security interest remains a purchase-money security interest, because a purchase-money security interest exists when the collateral secures only the debt incurred to obtain the collateral, not other debts.<sup>4</sup> If the purchase-money debt is renewed or refinanced, the resulting indebtedness is no longer a debt the debtor

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<sup>1</sup> A purchase-money security interest in consumer goods exists when the debtor finances its purchase of consumer goods using credit from the seller or a loan from a lender and grants the seller or lender a security interest in the goods purchased to secure the amount financed. U.C.C. § 9-103(a), (b)(1) (2005). Consumer goods means "goods that are used or bought for use primarily for personal, family, or household purposes." § 9-102(a)(23). Unless otherwise noted, all U.C.C. citations following are to the 2005 Official Text of the Uniform Commercial Code.

<sup>2</sup> U.C.C. § 9-103(f)(3) lists, but does not define, "refinanced." Black's Law Dictionary defines refinancing as: "An exchange of an old debt for a new debt, as by negotiating a different interest rate or term or by repaying the existing loan with money acquired from a new loan." BLACK'S LAW DICTIONARY 1285 (7th ed. 1999). The parties to a secured transaction might use the term "refinancing" regardless of whether the transaction has those incidents or is merely a renewal of an existing debt.

<sup>3</sup> U.C.C. § 9-103(f)(3) also lists "renewed" and also leaves it undefined. Black's Law Dictionary defines renewal as: "The re-creation of a legal relationship or the replacement of an old contract with a new contract, as opposed to the mere extension of a previous relationship or contract." BLACK'S LAW DICTIONARY 1299 (7th ed. 1999). Unless the context indicates otherwise, I will use "renewal" and "refinancing" interchangeably because I contend that the legal effect of either should be the same.

<sup>4</sup> U.C.C. § 9-103(a), (b).

incurred to obtain the collateral—the debtor had the collateral before the refinancing or renewal. Consequently, the purchase-money collateral does not secure a purchase-money obligation, and the security interest is “transformed” from a purchase-money security interest to a nonpurchase-money security interest.<sup>5</sup>

Frequently, the debtor borrows additional funds when refinancing or renewing the purchase-money obligation—a future advance under Article 9 of the Uniform Commercial Code.<sup>6</sup> Adding a future advance to the refinancing transaction creates an additional basis for asserting that the security interest is no longer purchase-money. In that instance, the future advance does not enable the debtor to obtain the purchase-money collateral; thus, part of the obligation is not purchase-money.

The classification of the security interest as purchase-money or nonpurchase-money is important for several reasons. First, a purchase-money security interest in consumer goods is perfected automatically under section 9-309(1) when it attaches; filing a financing statement is not necessary.<sup>7</sup> A security interest so perfected becomes unperfected if it is transformed from purchase-money to nonpurchase-money and the secured party has not perfected by another method.<sup>8</sup> The consequences of having an unperfected security interest can be disastrous if another creditor has a perfected security interest in the same collateral or if the debtor files

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<sup>5</sup> Courts and commentators have labeled this shift from a purchase-money security interest to a nonpurchase-money security interest the “transformation rule”: the security interest is transformed from purchase-money to nonpurchase-money. *See, e.g., In re Freeman*, 956 F.2d 252, 254 (11th Cir. 1992); *In re Blakeslee*, 377 B.R. 724, 730 (Bankr. M.D. Fla. 2007); U.C.C. § 9-103 cmt. 7a.

<sup>6</sup> “A security agreement may provide that collateral secures . . . future advances or other value, whether or not the advances or value are given pursuant to commitment.” U.C.C. § 9-204(c). Although Article 9 does not define future advance, a future advance occurs when a secured party extends additional credit to the debtor after giving the initial value required for attachment of the security interest under U.C.C. § 9-203(b). A secured party can make a future advance regardless of whether the debt is being refinanced or renewed.

<sup>7</sup> U.C.C. § 9-309(1). Perfection of most security interests requires an additional act beyond attachment. § 9-308(a). Section 9-309(1)’s perfection upon attachment generally does not operate for goods subject to a federal or state statute or treaty that adopts a perfection requirement for collateral. The most common example is a state statute for certificate of title goods that requires perfection of a security interest in goods covered by a certificate of title by indication of the security interest on a certificate of title. *See, e.g., KY. REV. STAT. ANN. § 186A.190* (LexisNexis Supp. 2010).

<sup>8</sup> U.C.C. § 9-308(b).

for bankruptcy. A perfected security interest always has priority over an unperfected security interest.<sup>9</sup> In bankruptcy, the trustee in bankruptcy can avoid an unperfected security interest.<sup>10</sup> Second, perfected purchase-money security interests have priority over conflicting perfected nonpurchase-money security interests in the same collateral.<sup>11</sup> Transformation from purchase-money to nonpurchase-money can result in loss of priority under the first-to-file-or-perfect priority rule of section 9-322(a) because the security interest that conflicts with the purchase-money security interest likely has an earlier filing date.<sup>12</sup> Third, a debtor in bankruptcy can avoid a nonpurchase-money, nonpossessory security interest in specific consumer goods.<sup>13</sup> Avoidance of the security interest means the creditor no longer has an interest in collateral that secures the debt owed by the debtor. The creditor has a claim in bankruptcy against the debtor, but not a secured claim.<sup>14</sup>

Finally, the Federal Trade Commission Consumer Lending Regulations make it an unfair trade practice for a lender or a retail installment seller to take from a consumer a nonpurchase-money, nonpossessory security interest in household goods.<sup>15</sup> Transformation might result in an unfair practice under the regulations.<sup>16</sup>

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<sup>9</sup> *Id.* § 9-322(a)(2).

<sup>10</sup> 11 U.S.C. § 544(a) (2010) (effective June 19, 1998).

<sup>11</sup> U.C.C. § 9-324(a). Section 9-324(a) supersedes the general first-to-file-or-perfect rule of priority of section 9-322(a).

<sup>12</sup> “Conflicting perfected security interests . . . rank according to priority in time of filing or perfection.” *Id.* § 9-322(a)(1).

<sup>13</sup> 11 U.S.C. § 522(f)(1)(B) (2010). This avoidance power, limited to nonpossessory and nonpurchase-money security interests, extends to household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, jewelry held primarily for the personal, family, or household use of the debtor or a dependent of the debtor, implements, professional books, or tools of the trade of the debtor or the trade of a dependent of the debtor, and professionally prescribed health aids for the debtor or a dependent of the debtor. *Id.*

<sup>14</sup> § 101(5); *see also* § 506(a).

<sup>15</sup> 16 C.F.R. § 444.2(a)(4) (2010). 16 C.F.R. § 444.1(i) defines household goods.

<sup>16</sup> *See* 16 C.F.R. § 444.2(a) (2010).

A rebuttal to transformation is that it promotes form over substance.<sup>17</sup> It is a reasonable proposition that the obligation created in the refinancing transaction replaces the original purchase-money loan; thus, the refinanced obligation is not incurred to obtain the purchase-money collateral. In reality, however, the obligation is the same as it was, albeit in a different promissory note or loan agreement. It still represents a debt incurred to purchase the collateral and should be considered a purchase-money obligation.<sup>18</sup>

Rebuttal to transformation is also appropriate when a purchase-money secured party makes a future advance. After a future advance, the secured obligation consists of two parts: a purchase-money part—the debt incurred to purchase the collateral—and a nonpurchase-money part—the future advance.<sup>19</sup> Likewise, the security interest consists of two parts: a purchase-money part and a nonpurchase-money part.<sup>20</sup> This is a “dual status” security interest—the security interest has a status of purchase-money and a status of nonpurchase-money.<sup>21</sup>

Prior to the enactment of Revised Article 9, many courts found statutory authority for dual status in section 9-107 of former Article 9.<sup>22</sup> Section 9-107 adopted a definition of a purchase-money security interest that operated “to the extent that” the security interest satisfied the value and collateral requirements of the

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<sup>17</sup> See *In re Geist*, 79 B.R. 939, 942 (D. Wyo. 1987); *In re Conn* 16 B.R. 454, 459 (Bankr. W.D. Ky. 1982); David Gray Carlson, *Purchase Money Under the Uniform Commercial Code*, 29 IDAHO L. REV. 793, 851 (1992).

<sup>18</sup> See U.C.C. § 9-103(a)(2).

<sup>19</sup> § 9-204(c).

<sup>20</sup> See § 9-103 cmt. 7a.

<sup>21</sup> *Id.*

<sup>22</sup> See *In re Billings*, 838 F.2d 405, 408 (10th Cir. 1988); *Pristas v. Landaus of Plymouth, Inc.*, 742 F.2d 797, 801 (3d Cir. 1984); *In re Geist*, 79 B.R. 939, 943 (D. Wyo. 1987); *In re McAllister*, 267 B.R. 614, 620 (Bankr. N.D. Iowa 2001); *In re Short*, 170 B.R. 128, 134 (Bankr. S.D. Ill. 1994); *In re Russell*, 29 B.R. 270, 273 (Bankr. W.D. Okla. 1983); *In re Conn*, 16 B.R. 454, 457 (Bankr. W.D. Ky. 1982); *In re Gibson*, 16 B.R. 257, 267 (Bankr. D. Kan. 1981). Yet, not all courts agreed. See, e.g., *In re Freeman*, 956 F.2d 252 (11th Cir. 1992); *In re Matthews*, 724 F.2d 798, 801 (9th Cir. 1984).

section.<sup>23</sup> These courts believed that “to the extent” authorized a security interest that is part purchase-money and part nonpurchase-money.<sup>24</sup>

A shortcoming of the dual status rule was that it did not solve the problem of how to ascertain what part of the total indebtedness is purchase-money and what part is not purchase-money after the debtor makes a payment on the obligation. In other words, how is a payment allocated between the purchase-money and nonpurchase-money parts of the obligation? Some courts were unwilling to make the allocation. Consequently, unless the parties’ agreement or other law implemented an allocation method, these courts would declare the entire security interest a nonpurchase-money security interest regardless of whether they accepted the dual status rule.<sup>25</sup>

The opportunity for the drafters of Article 9 to resolve the issue came with the drafting of Revised Article 9.<sup>26</sup> The drafters chose the dual status rule:

[A] purchase-money security interest does not lose its status as such, even if:

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<sup>23</sup> Section 9-107. Definitions: “Purchase Money Security Interest”.

A security interest is a ‘purchase money security interest’ to the extent that it is

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

U.C.C. § 9-107 (1962).

<sup>24</sup> See *In re Billings*, 838 F.2d 405, 408 (10th Cir. 1988); *Pristas v. Landaus of Plymouth, Inc.*, 742 F.2d 797, 801 (3d Cir. 1984); *In re Geist*, 79 B.R. 939, 943 (D. Wyo. 1987); *In re McAllister*, 267 B.R. 614, 620 (Bankr. N.D. Iowa 2001); *In re Short*, 170 B.R. 128, 134 (Bankr. S.D. Ill. 1994); *In re Russell*, 29 B.R. 270, 273 (Bankr. W.D. Okla. 1983); *In re Conn*, 16 B.R. 454, 457 (Bankr. W.D. Ky. 1982); *In re Gibson*, 16 B.R. 257, 267 (Bankr. D. Kan. 1981).

<sup>25</sup> *Southtrust Bank of Ala., Nat’l Ass’n v. Borg-Warner Acceptance Corp.*, 760 F.2d 1240, 1243 (11th Cir. 1985); *Coomer v. Barclays Am. Fin., Inc.*, 8 B.R. 351, 355 (Bankr. E.D. Tenn. 1980).

<sup>26</sup> The Permanent Editorial Board (PEB) Study Group Uniform Commercial Code Article 9 began studying revision of Article 9 in 1990. PERMANENT EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE, PEB STUDY GROUP UNIFORM COMMERCIAL CODE ARTICLE 9 REPORT 1 (Dec. 1, 1992) [hereinafter “PEB REPORT”].

- (1) the purchase-money collateral also secures an obligation that is not a purchase-money obligation;
- (2) collateral that is not purchase-money collateral also secures the purchase-money obligation; or
- (3) the purchase-money obligation has been renewed, refinanced, consolidation, or restructured.<sup>27</sup>

While making dual status definite, the drafters recognized that some courts “have found [the dual status] rule to be explicit or implicit in the words ‘to the extent.’”<sup>28</sup> Additionally, the drafters adopted a method for allocating payments on the debt made by the debtor.<sup>29</sup>

Regrettably, the drafters did not resolve these issues as they pertain to purchase-money security interests in consumer-goods transactions.<sup>30</sup> A compromise among the drafting committee members culminated in limiting the dual status and payment rules to a purchase-money security interest transaction “other than a consumer-goods transaction . . . .”<sup>31</sup> The drafters clearly intended to let the courts address whether the dual status rule should apply to consumer purchase-money security interests:

The limitation of the rules in subsections (e), (f), and (g) to transactions other than consumer-goods transactions is intended to leave to the court the determination of the proper rules in consumer-goods transactions. The court may not infer from that limitation the

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<sup>27</sup> U.C.C. § 9-103(f).

<sup>28</sup> § 9-103 cmt. 7a.

<sup>29</sup> § 9-103(e). The allocation of payment rules are discussed in cmt. 7b.

<sup>30</sup> A “consumer-goods transaction” results when an individual “incurs an obligation primarily for personal, family, or household purposes” and secures the obligation with goods used or bought for use primarily for personal, family, or household purposes. § 9-102(a)(23), (24). Basically, a consumer-goods transaction is a security interest in which consumer goods secure a consumer obligation. It becomes a consumer goods purchase-money security interest transaction when the consumer goods secure the credit that enabled the individual to obtain the goods or the rights to the goods.

<sup>31</sup> § 9-103(e), (f), (g). Professor Mooney labels it the “consumer compromise.” Charles W. Mooney, Jr., *The Consumer Compromise in Revised U.C.C. Article 9: The Shame of It All*, 68 OHIO ST. L.J. 215 (2007); see also Jean Braucher, *Deadlock: Consumer Transactions Under Revised Article 9*, 73 AM. BANKR. L.J. 83, 95-98 (1999). Part IV discusses the compromise.

nature of the proper rule in consumer-goods transactions and may continue to apply established approaches.<sup>32</sup>

Courts encountering the issue are not without help from Article 9. A court's decision must comport with the definition of purchase-money security interest in section 9-103. Section 9-103 aligns with previous Article 9 texts, defining a purchase-money security interest using the words "to the extent."<sup>33</sup> "A security interest in goods is a purchase-money security interest . . . to the extent that the goods are purchase-money collateral with respect to that security interest."<sup>34</sup> These words authorize a security interest that is part purchase-money and part nonpurchase-money. To the extent that a future advance accompanies a refinancing, the security interest is part purchase-money and part nonpurchase-money.<sup>35</sup> To the extent that a purchase-money security interest is refinanced with no future advance, it remains a purchase-money security interest.<sup>36</sup> The definition of purchase-money security interest should persuade a court that dual status is the appropriate rule.<sup>37</sup> Parts V and VI of this article present the case for adopting dual status and payment rules.

Cases discussing "to the extent" under the purchase-money security interest definition of section 9-107 of former Article 9 are relevant because sections 107 and 103 of Article 9 use similar words to define purchase-money security interest. Part II summarizes the rationale of these cases. Part III examines the drafting process of Revised Article 9, which reveals the intent of the drafters regarding the effect of refinancing. Part IV reviews the "consumer compromise," which thrusts this issue to the courts. Finally, Part VII surveys current case law and legislation.

## II. DUAL STATUS UNDER SECTION 9-107 OF FORMER ARTICLE 9

Soon after the states enacted the U.C.C., courts faced the issue of whether a purchase-money security interest retains its purchase-money status if the security

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<sup>32</sup> U.C.C. § 9-103(h).

<sup>33</sup> See § 9-103.

<sup>34</sup> § 9-103(b)(1).

<sup>35</sup> See *supra* notes 2-6 and accompanying text; *infra* Part V.

<sup>36</sup> See *supra* notes 2-6 and accompanying text; *infra* Part V.

<sup>37</sup> I discuss various methods of allocating payments in Part VI.

agreement includes a future advance clause or the purchase-money obligation is renewed or refinanced.<sup>38</sup> Their decisions fell into one of three categories: allowing the security interest to have dual status,<sup>39</sup> applying transformation from purchase-money to nonpurchase-money,<sup>40</sup> or allowing the decision to rest on whether there is a method for allocating payments.<sup>41</sup> Early comments on this issue by academics agreed that the language of section 9-107 favored dual status.<sup>42</sup>

Courts that adopted dual status—a security interest can be part purchase-money and part nonpurchase-money—typically based their decision on the words of section 9-107:

A security interest is a “purchase money security interest” to the extent that it is

(a) taken or retained by the seller of the collateral to secure all or part of its purchase price; or

(b) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.<sup>43</sup>

*In re Billings*, a Tenth Circuit Court of Appeals opinion, is representative of such decisions.<sup>44</sup>

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<sup>38</sup> *E.g.*, *In re Simpson*, 4 U.C.C. Rep. Serv. (CBC) 243, 247 (W.D. Mich. 1966). The issue arose more frequently after October 1, 1979, the effective date of the modern Bankruptcy Code, because the Bankruptcy Code enabled the debtor, through 11 U.S.C. § 522(f), to avoid a security interest. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, Title IV, § 402, 92 Stat. 2682.

<sup>39</sup> *See, e.g.*, *In re Billings*, 838 F.2d 405, 410 (10th Cir. 1988).

<sup>40</sup> *See, e.g.*, *In re Manuel*, 507 F.2d 990, 993 (5th Cir. 1975).

<sup>41</sup> *See, e.g.*, *In re Slay*, 8 B.R. 355, 358 (Bankr. E.D. Tenn. 1980).

<sup>42</sup> *See* Mary Aronov, *The Transformation Rule Applied to Purchase Money Security Interests in Commercial Lending Transactions*, 16 MEM. ST. U. L. REV. 15, 58 (1985); Bernard A. Burk, *Preserving the Purchase Money Status of Refinanced or Commingled Purchase Money Debt*, 35 STAN. L. REV. 1133, 1143-44 (1983); Robert M. Lloyd, *Refinancing Purchase Money Security Interests*, 53 TENN. L. REV. 1, 64 (1985); Gerald T. McLaughlin, *“Add On” Clauses in Equipment Purchase Money Financing: Too Much of a Good Thing*, 49 FORDHAM L. REV. 661, 682 (1981); Ann E. Conaway Stilson, *The “Overloaded” PMSI in Bankruptcy: A Problem in Search of a Resolution*, 60 TEMP. L.Q. 1, 31 (1987).

<sup>43</sup> U.C.C. § 9-107 (1995). Revised Article 9 first hyphenated “Purchase-money” in 2001.

<sup>44</sup> *In re Billings*, 838 F.2d 405, 408-09 (10th Cir. 1988).

In *Billings*, the debtors and the purchase-money secured creditor refinanced a purchase-money loan for consumer goods by cancelling the original promissory note and replacing it with a new note and security agreement.<sup>45</sup> After filing for bankruptcy, the debtors attempted to avoid the security interest by using 11 U.S.C. 522(f)(2), contending that the security interest was no longer purchase-money.<sup>46</sup> The court rejected the argument that a security interest cannot be a purchase-money security interest if the collateral secures more than its purchase price.<sup>47</sup> According to the court, such a result “ignores the precise wording of the Uniform Commercial Code.”<sup>48</sup> The language “to the extent” in section 9-107 “would be meaningless if an obligation could never be considered only partly a purchase money debt.”<sup>49</sup> Other circuit, district, and bankruptcy courts have also adopted this rationale.<sup>50</sup>

Courts that apply the transformation rule—the purchase-money security interest is transformed into a nonpurchase-money security interest—typically base their decision on section 9-107, which states that the obligation of a purchase-money security interest is the purchase price or enabling loan of the collateral.<sup>51</sup> When a purchase-money security interest includes a future advance clause and the secured party makes a future advance, the obligation is no longer only the price or enabling loan; consequently, the security interest is not a purchase-money security interest.<sup>52</sup> When the obligation of a purchase-money security interest is refinanced or renewed and a new obligation created, the new obligation does not enable the debtor to purchase or acquire rights in the collateral because the debtor already has those

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<sup>45</sup> A very small cash advance (\$9.67) accompanied the refinancing. *Id.* at 406.

<sup>46</sup> *Id.*

<sup>47</sup> *Id.* at 410.

<sup>48</sup> *Id.* at 408.

<sup>49</sup> *Id.*

<sup>50</sup> See *Pristas v. Landaus of Plymouth, Inc.*, 742 F.2d 797, 800-01 (3rd Cir. 1984); *In re Geist*, 79 B.R. 939, 942 (D. Wyo. 1987); *In re McAllister*, 267 B.R. 614, 620 (Bankr. N.D. Iowa 2001); *In re Short*, 170 B.R. 128, 136 (Bankr. S.D. Ill. 1994); *In re Russell*, 29 B.R. 270, 273 (Bankr. W.D. Okla. 1983); *In re Conn*, 16 B.R. 454, 457 (Bankr. W.D. Ky. 1982); *In re Gibson*, 16 B.R. 257, 267 (Bankr. D. Kan. 1981).

<sup>51</sup> See, e.g., *In re Manuel*, 507 F.2d 990, 993 (5th Cir. 1975); *In re Norrell*, 426 F. Supp. 435, 436 (M.D. Ga. 1977).

<sup>52</sup> *Manuel*, 502 F.2d at 993.

rights.<sup>53</sup> Consequently, the transaction does not satisfy the “present consideration” requirement described by the drafters in section 9-107, Official Comment 2.<sup>54</sup>

*In re Simpson* is the oft-cited seminal case for the proposition that a security interest cannot be purchase-money if the obligation secured includes future advances, although the case was decided on other grounds.<sup>55</sup> In *Simpson* the security interest secured the purchase price of farm equipment and the security agreement provided that the collateral was security for “future indebtedness.”<sup>56</sup> At that time, U.C.C. § 9-302(1)(c) did not require filing a financing statement in order to perfect a purchase-money security interest in farm equipment having a purchase price not in excess of \$2500.00.<sup>57</sup> When the debtor filed for bankruptcy, the trustee in bankruptcy moved to avoid the security interest, contending it was unperfected because the “future indebtedness” clause prevented the security interest from being a purchase-money security interest.<sup>58</sup> The court explained that, except for the “future indebtedness” provision, the security agreement would have created a purchase-money security interest.<sup>59</sup> Citing the drafters’ statement in section 9-107, Official Comment 2 that a security interest taken as security for a pre-existing claim or antecedent debt is excluded from purchase-money status, the court found no distinction between an antecedent debt and a future advance.<sup>60</sup> Either type of debt

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<sup>53</sup> *In re Matthews*, 724 F.2d 798, 800-01 (9th Cir. 1984).

<sup>54</sup> “When a purchase money interest is claimed by a secured party who is not a seller, he must of course have given present consideration.” U.C.C. § 9-107 cmt. 2 (1962).

<sup>55</sup> *In re Simpson*, 4 U.C.C. Rep. Serv. (CBC) 243, 247 (W.D. Mich. 1966). The issue was perfection of the security interest, and the referee in bankruptcy held that the security interest was perfected by the secured party’s possession of the collateral.

<sup>56</sup> *Id.* at 246.

<sup>57</sup> U.C.C. § 9-302(1)(c) (1962). The secured party nevertheless filed a financing statement. However, the filed financing statement did not perfect the security interest because the secured party did not file the financing statement in the county of the debtor’s residence, as was required by Michigan’s version of section 9-401. In previous official texts of Article 9, section 9-401 stipulated the office where the secured party must file the financing statement. *E.g.*, U.C.C. § 9-401 (1995).

<sup>58</sup> *Simpson*, 4 UCC Rep. Serv. (CBC) at 249.

<sup>59</sup> *Id.*

<sup>60</sup> When a purchase money interest is claimed by a secured party who is not a seller, he must of course have given present consideration. This Section therefore provides that the purchase money party must be one who gives value “by making advances or incurring an obligation”: the quoted language excludes from the

could prevent purchase-money status.<sup>61</sup> Other courts have agreed with the *Simpson* rationale.<sup>62</sup>

Courts also applied the transformation rule when the parties refinanced the purchase-money obligation. *In re Matthews* is representative of those cases.<sup>63</sup> The secured party refinanced the original purchase-money loan and issued a new loan from which the debtors paid off the original loan and received additional cash.<sup>64</sup> Upon filing for bankruptcy, the debtors attempted to avoid the security interest in the collateral using 11 U.S.C. § 522(f), arguing that the security interest was no longer purchase-money.<sup>65</sup> The court agreed with the “vast majority of courts” that refinancing by paying off the old loan and extending a new loan extinguishes the purchase-money character of the original loan because the debtor does not use the new loan to acquire rights in the collateral.<sup>66</sup> The court cited approvingly the words of the comment to section 9-107 that excluded pre-existing claims or antecedent debt obligations from purchase-money status.<sup>67</sup>

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purchase money category any security interest taken as security for or in satisfaction of a preexisting claim or antecedent debt.

U.C.C. § 9-107 cmt. 2 (1962).

<sup>61</sup> The court recognized the “to the extent” language of section 9-107 but believed that the comment to the section indicated that the drafters did not intend such a literal reading. *Simpson*, 4 U.C.C. Rep. Serv. (CBC) at 247.

<sup>62</sup> See generally *In re Freeman*, 956 F.2d 252 (11th Cir. 1992) (holding if a security interest secures some other type of debt, it is not a purchase-money security interest); *In re Manuel*, 507 F.2d 990 (5th Cir. 1975) (security interest was not purchase-money because the collateral did not solely secure its price); *In re Norrell*, 426 F. Supp. 435 (M.D. Ga. 1977) (finding the security agreement provided that collateral covered indebtedness other than its price and thus there was no purchase-money security interest in any collateral); *In re Jones*, 5 B.R. 655 (Bankr. M.D.N.C. 1980) (reasoning the presence of a future advance clause is sufficient to extinguish the purchase money character of the security interest).

<sup>63</sup> *In re Matthews*, 724 F.2d 798 (9th Cir. 1984); see also *In re Keeton*, 161 B.R. 410 (Bankr. S.D. Ohio 1993); *In re Higgs*, 89 B.R. 264 (Bankr. N.D. Ga. 1988); *In re Faughn*, 69 B.R. 18 (Bankr. E.D. Mo. 1986).

<sup>64</sup> *Matthews*, 724 F.2d at 799.

<sup>65</sup> *Id.* at 799-800.

<sup>66</sup> *Id.* at 800.

<sup>67</sup> *Id.* at 801.

The refinancing cases arguably present the best case for applying the transformation rule. If the purchase-money obligation is refinanced in a transaction that cancels the original obligation and extends a new loan, then the purchase-money collateral arguably does not secure the purchase price of the collateral or enable the debtor to purchase the collateral because the debtor does not acquire the collateral with the new loan. The essence of purchase-money, both then and now, is that the value the secured party gives the debtor enables the debtor to acquire the collateral or rights in the collateral.<sup>68</sup>

Some courts employed the dual status or transformation rule depending on whether the contract or other law provided a method for allocating payments. In *Southtrust Bank of Alabama, National Association v. Borg-Warner Acceptance Corporation*, the secured party contended that the court should adopt a “to the extent” rule based on the literal language of U.C.C. § 9-107.<sup>69</sup> The court rejected this offer, stating that “[u]nless a lender contractually provides some method for determining the extent to which each item of collateral secures its purchase money, it effectively gives up its purchase money status.”<sup>70</sup> The bankruptcy judge in *In re Slay* agreed with the principle that, when a purchase-money loan is consolidated with a nonpurchase-money loan, the lender gives up its purchase-money status because “there is no method of apportioning the loan between purchase money and nonpurchase money and no method of applying the payments to the parts.”<sup>71</sup> However, the court allowed part purchase-money status because the debtor made no payments and the court could “easily determine the amount of the purchase money debt.”<sup>72</sup> The same bankruptcy judge applied the transformation rule in a case in which no apportionment method existed, stating that “[w]ithout some guidelines, legislative or

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<sup>68</sup> U.C.C. § 9-103(a), (b)(1) (2005); U.C.C. § 9-107 (1972); U.C.C. § 9-107 (1962).

<sup>69</sup> *Southtrust Bank of Ala., Nat’l Ass’n v. Borg-Warner Acceptance Corp.*, 760 F.2d 1240, 1243 (11th Cir. 1985). Although the secured party had a security interest in the debtor’s inventory and the issue was priority of a purchase-money security interest, the court saw “no reason to limit the holding of *In re Manuel* to consumer bankruptcy cases.” *Id.* at 1242.

<sup>70</sup> *Id.* at 1243.

<sup>71</sup> *In re Slay*, 8 B.R. 355, 358 (Bankr. E.D. Tenn. 1980).

<sup>72</sup> *Id.*; see also *In re Ionosphere Clubs, Inc.*, 123 B.R. 166 (S.D.N.Y. 1991). In *Ionosphere*, a case involving a security interest in equipment, the judge found an appropriate apportionment method from the culmination of the purchase-money loan consolidation in a series of promissory notes with each series representing the financed amount of the purchase price of an item of collateral. *Ionosphere*, 123 B.R. at 173.

contractual, the court should not be required to distill from a mass of transactions the extent to which a security interest is purchase money.”<sup>73</sup>

Not all courts required a contractual or statutory apportionment method as a condition to applying the dual status rule. *In re Conn* is one of the first cases in which a judge created an apportionment method in the absence of a contract or statutory method.<sup>74</sup> The debtors had refinanced a consumer goods purchase-money obligation and received an additional \$700 in the refinancing transaction.<sup>75</sup> After filing for bankruptcy, they sought to avoid the security interest under 11 U.S.C. § 522(f) on the grounds that the refinancing destroyed the purchase-money status.<sup>76</sup> Although recognizing the difficulty of apportioning the debt, even when a contractual or statutory allocation method exists, the court stated that the task “is not so burdensome that a court cannot apply its own formula in the absence of a contractual or statutory apportionment method.”<sup>77</sup> It adopted a “first-in, first-out” method under which payments were applied “to the price of items in the order in which those items were purchased.”<sup>78</sup> For the refinanced loan, payments were applied first to the outstanding balance of the first note that had been transferred to the second note.<sup>79</sup> The court believed that this method could be easily applied, facilitated fairness, and created certainty of result for the parties.<sup>80</sup> Other courts have agreed.<sup>81</sup>

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<sup>73</sup> *Coomer v. Barclays Am. Fin., Inc.*, 8 B.R. 351, 355 (Bankr. E.D. Tenn. 1980).

<sup>74</sup> *In re Conn*, 16 B.R. 454, 458 (Bankr. W.D. Ky. 1982).

<sup>75</sup> *Id.* at 455.

<sup>76</sup> *Id.*

<sup>77</sup> *Id.* at 458.

<sup>78</sup> *Id.*

<sup>79</sup> *Id.* at 459.

<sup>80</sup> *Id.*

<sup>81</sup> See *In re Short*, 170 B.R. 128, 136 (Bankr. S.D. Ill. 1994) (applying first-in first-out to purchase-money loan consolidated with nonpurchase-money loan); *In re Clark*, 156 B.R. 693, 695 (Bankr. S.D. Fla. 1993) (applying first-in first-out methodology in the absence of a provision in the loan documents); *In re Parsley*, 104 B.R. 72, 75 (Bankr. S.D. Ind. 1988) (first-in first-out is equitable and consistent with legislative intent and state concerns); *In re Russell*, 29 B.R. 270, 274 (Bankr. W.D. Okla. 1983) (first-in first-out is an easily-applied rule of thumb that promotes equity and certainty); *In re Gibson*, 16 B.R. 257, 269 (Bankr. D. Kan. 1981) (a lien is a purchase-money lien until the purchase price of the item is paid applying a first-in, first-out method of payment allocation).

Reviewing these cases reveals that there was no uniform approach by courts. A court could cite section 9-107 and its comment to justify adopting dual status or transformation. Likewise, if a debtor had made a payment of the debt, a court could base its decision on its inability to determine the constituent parts of the security interest. Thus, legislative action was needed.

### III.    EARLY DRAFTS OF SECTION 9-103 OF REVISED ARTICLE 9

Section 9-107 had defined “purchase-money security interest” since the inception of UCC Article 9.<sup>82</sup> The 1972 amendments to Article 9 made no changes to section 9-107.<sup>83</sup> In 1990, the Permanent Editorial Board (PEB) for the Uniform Commercial Code established a committee to study Article 9 and recommend any revisions.<sup>84</sup> This would be the opportunity for the drafters to decide whether to adopt transformation or dual status. The committee’s drafts provide insight into their intent.

#### *A. The 1992 PEB Study Committee Report*

The PEB Study Committee chose dual status.<sup>85</sup> It proposed revisions to section 9-107 to clarify that: 1) a security interest can be a purchase-money security interest notwithstanding that the security interest secures non-purchase-money debt; and 2) a renewal, refinancing, or other restructuring does not terminate the purchase money status of a security interest.<sup>86</sup> Although noting the opposing view of a

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<sup>82</sup> U.C.C. § 9-107 (1962).

<sup>83</sup> Compare U.C.C. § 9-107 (1962), with U.C.C. § 9-107 (1972).

<sup>84</sup> See PEB REPORT, *supra* note 26, at 1. The American Law Institute (ALI) and the National Conference of Commissioners on Uniform State Laws (NCCUSL), the sponsors of the Permanent Editorial Board, concurred in the establishment of a study committee. *Id.* Throughout the drafting process, the various committees studying Article 9 presented drafts to ALI and to NCCUSL. Occasionally the drafts differed, but mostly they included the same recommendations.

<sup>85</sup> PEB REPORT, *supra* note 26, at 97.

<sup>86</sup> “The definition of ‘purchase-money security interest’ (PMSI) in § 9-107 should be revised to make clear that:

1. A security interest may be a PMSI notwithstanding (i) the fact that the collateral also secures other, non-purchase money debt . . .
2. A renewal, refinancing, or other restructuring of the debt secured does not destroy the purchase money character of a security interest.”

PEB REPORT, *supra* note 26, at 97.

substantial body of case law, the committee stated that the proposed revisions “would yield the results that obtain under a proper application of current law.”<sup>87</sup> Use of the phrase “a proper application of current law” evidences the committee’s belief that the “to the extent” language of section 9-107 already warranted dual status. Additional reasons for recommending dual status listed by the committee were: 1) it gives the parties flexibility in deciding what collateral secures the obligations; 2) the favored treatment of purchase-money security interests; and 3) consensual refinancing should not be discouraged.<sup>88</sup> The recommended definition treated all purchase-money security interests the same regardless of the type of goods.

A further recommendation from the study committee was that the drafting committee should “consider” whether to adopt an allocation of payments formula to operate in the absence of agreement by the parties.<sup>89</sup> The study committee recommended only that the drafting committee consider a formula because they “did not reach consensus on the desirability of including a formula.”<sup>90</sup> Their stated concerns were whether a formula would yield “appropriate results under a wide array of circumstances” and whether a statutory formula would restrict the parties’ ability to allocate payments by agreement.<sup>91</sup>

#### B. *Drafts of the Purchase-Money Security Interest Definition*

A drafting committee was established in 1993 pursuant to the recommendation of the study committee.<sup>92</sup> The drafting committee published a discussion draft for the American Law Institute (ALI) dated April 16, 1996. The

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<sup>87</sup>*Id.* at 98. The “Committee Recommendations” additionally approved purchase-money status notwithstanding that the purchase-money debt is secured by other collateral and placed the burden of proving the extent to which the security interest is purchase-money, including allocation of payments between purchase-money and non-purchase-money, on the secured party. *Id.* at 97.

<sup>88</sup> *Id.* at 98.

<sup>89</sup> *Id.* at 99. Because the committee had recommended that the secured party bear the burden of proving the extent to which the security interest was a purchase-money security interest, they suggested the parties include an allocation formula in the security agreement. *Id.*

<sup>90</sup> *Id.*

<sup>91</sup> *Id.* at 99-100.

<sup>92</sup> UNIFORM COMMERCIAL CODE REVISED ARTICLE 9 at xxxi (Discussion Draft, Apr. 16, 1996) [hereinafter “April 1996 Discussion Draft”]. Many of the various drafts are reproduced by the Biddle Law Library Archives at the University of Pennsylvania Law School, <http://www.law.upenn.edu/bll/archives/ulc/ulc.htm#ucc9>.

published draft defined purchase-money security interest in proposed section 9-107.<sup>93</sup> The committee adopted the dual status rule to retain purchase-money status both when the purchase-money collateral secures other obligations and when the purchase-money obligation is renewed, refinanced, or restructured.<sup>94</sup> The definition applied to all purchase-money security interests, and consumer goods purchase-money security interests were likewise protected by the dual status rule.<sup>95</sup>

The drafting committee also adopted a payment application rule, which applied to all purchase-money security interests.<sup>96</sup> Under the rule, payments are allocated in accordance with the parties' reasonable agreement, or in the absence of such agreement, in accordance with intention of the obligor, or in the absence of intention, first to unsecured obligations and then to purchase-money obligations in the order they were incurred.<sup>97</sup>

The National Conference of Commissioners on Uniform State Laws (NCCUSL) draft included a payment application rule similar to the ALI Draft. However, the Reporters for the NCCUSL draft advised the drafting committee against including an allocation formula.<sup>98</sup> They based their reservations on the belief that “[a]ny [allocation] scheme has potential for mischief, such [as] forcing a

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<sup>93</sup> April 1996 Discussion Draft, *supra* note 92, at 21. The committee wrote the statutory text of the draft on February 15, 1996. See April 1996 Discussion Draft, *supra* note 92, at xxxi. Although the Reporters' Prefatory Comments to the April Draft refer to a November 15, 1995 draft of revisions to Article 9, I have been unable to locate a copy of it. See *id.* I have no reason to think it would have defined purchase-money security interest differently.

<sup>94</sup> *Id.* at 22. The February 1996 NCCUSL Draft published the same dual status rule as the ALI. UNIFORM COMMERCIAL CODE REVISED ARTICLE 9 at § 9-107(e) (Draft, Feb. 1996) [hereinafter “February 1996 NCCUSL Draft”], available at <http://www.law.upenn.edu/bll/archives/ulc/ucc9/fb96ucc9.htm> (last visited Feb. 8, 2011).

<sup>95</sup> Throughout this article, I use the term “consumer goods purchase-money security interest” to mean a purchase-money security interest in a consumer-goods transaction.

<sup>96</sup> The new payment application rule adopted by the drafting committee is the same as the current U.C.C. § 9-103(e).

<sup>97</sup> April 1996 Discussion Draft, *supra* note 92, at 22. The only difference between the Discussion Draft and the current section 9-103 is in the numbering of the subparts of the section.

<sup>98</sup> See February 1996 NCCUSL Draft, *supra* note 94, at § 9-107(e), Reporters' Explanatory Note 5, available at <http://www.law.upenn.edu/bll/archives/ulc/ucc9/fb96ucc9.htm> (last visited Feb. 8, 2011). The ALI Draft did not include section notes.

prepayment of low interest debt while leaving outstanding high interest debt.”<sup>99</sup> As support for this belief, the committee referred to experience under the Bankruptcy Code indicating that the determination of when a debt was incurred, as would be required by section 9-107, “is not so simple.”<sup>100</sup> Finally, the committee recognized that other statutes could provide an allocation method different from Article 9, thus creating a conflict of laws.<sup>101</sup>

*C. Report of the Consumer Issues Subcommittee of the UCC Article 9 Drafting Committee*

The Consumer Issues Subcommittee was established to consider and make recommendations regarding consumer issues in the Article 9 revision process.<sup>102</sup> One issue the subcommittee examined was the effect of the proposed dual status rule on a consumer goods purchase-money security interest. The subcommittee agreed with the recommendation of the drafting committee that a purchase-money security interest can be dual status.<sup>103</sup> The subcommittee’s reasoning was rooted in the wording of existing section 9-107. The subcommittee noted that although section 9-107 did not specifically continue purchase-money status after a refinancing, it did provide that a security interest is purchase-money “to the extent that it is taken’ by the seller to secure the price or by a lender who makes a loan to enable the debtor to acquire the collateral.”<sup>104</sup> Such language “provides a strong argument that the drafters contemplated that a debt might be partly purchase money and partly non-purchase money.”<sup>105</sup>

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<sup>99</sup> *Id.*

<sup>100</sup> *Id.* The Bankruptcy Code reference was to 11 U.S.C. § 547(c)(2) (1982) (effective Nov. 6, 1978), the “ordinary course of business” exception to avoidance of a preference. As originally enacted, section 547(c)(2) created an exception for ordinary course payments made not later than 45 days after the debt was incurred, thus requiring the determination of when the debt was incurred.

<sup>101</sup> February 1996 NCCUSL Draft, *supra* note 94, at § 9-107(e), Reporters’ Explanatory Note 5.

<sup>102</sup> REPORT OF THE CONSUMER ISSUES SUBCOMMITTEE OF THE UCC ARTICLE 9 DRAFTING COMMITTEE (1996), *reprinted in* 50 CONSUMER FIN. L.Q. REP. 332, Ed. Note (1996) [hereinafter “CONSUMER ISSUES SUBCOMMITTEE REPORT”]. Previously, the chair of the Article 9 Drafting Committee had formed a Consumer Issues Task Force to achieve that result, but the task force never reached agreement on consumer proposals. *See* Marion W. Benfield, Jr., *Consumer Provisions in Revised Article 9*, 74 CHI.-KENT L. REV. 1255, 1257 (1999).

<sup>103</sup> CONSUMER ISSUES SUBCOMMITTEE REPORT, *supra* note 102, at 341-42.

<sup>104</sup> *Id.* at 341.

<sup>105</sup> *Id.*

The report notes that the consumer representatives on the subcommittee asked that the dual status recommendation of the drafting committee not apply to consumer loans.<sup>106</sup> Their goal was to preserve the power of bankruptcy courts to apply the transformation rule to a refinanced purchase-money security interest in consumer goods so that a debtor could avoid a nonpossessory, nonpurchase-money security interest using 11 U.S.C. § 522(f).<sup>107</sup> The subcommittee, however, rejected limiting the scope of dual status. Instead, they recommended adding a comment to section 9-107 to clarify that bankruptcy courts are free to apply the transformation rule.<sup>108</sup> This decision seems based partly on their observation that many bankruptcy judges rest their decisions regarding dual status on section 9-107, because the Bankruptcy Code does not define purchase-money security interest.<sup>109</sup> Nevertheless, the subcommittee agreed that bankruptcy judges are free to reject the Article 9 definition of purchase-money security interest if they believe the policy of the Bankruptcy Code justifies a different result.<sup>110</sup>

The subcommittee was aware that some courts apply the transformation rule after a refinancing accompanied by a future advance because they are unable to determine which part of the loan is purchase-money and which part is nonpurchase-money.<sup>111</sup> The report commented favorably on the various approaches courts had taken to solving that problem: using the apportionment rule stated in the agreement, adopting a statutorily mandated rule, or fashioning their own rule.<sup>112</sup> It also observed, “We are told that currently, most consumer purchase money contracts provide a method of allocation of payments after a consolidation or refinancing, so

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<sup>106</sup> *Id.* The report did not disclose the names of the consumer representatives. The subcommittee members were Professor Marion Benfield, Chair, Henry Kittleson, Sandra Stern, and Neil Cohen. *Id.* at 332, Ed. Note.

<sup>107</sup> *Id.* at 341.

<sup>108</sup> *Id.*

<sup>109</sup> *Id.* at 342. *See, e.g., In re Billings*, 838 F.2d 405, 406 (10th Cir. 1988); *Pristas v. Landaus*, 742 F.2d 797, 800 (3rd Cir. 1984); *In re Manuel*, 507 F.2d 990, 992-93 (5th Cir. 1975).

<sup>110</sup> CONSUMER ISSUES SUBCOMMITTEE REPORT, *supra* note 102, at 342. Official Comment 8 to U.C.C. § 9-103 expresses that opinion.

<sup>111</sup> CONSUMER ISSUES SUBCOMMITTEE REPORT, *supra* note 102, at 341.

<sup>112</sup> *Id.*

that the apportionment problem rationale for denying ‘dual status’ has largely disappeared.”<sup>113</sup>

*D. Changes to the Payment Rule for a Consumer Goods Purchase-Money Security Interest*

Without explanation, the reporters for the drafting committee added an application-of-payments rule applicable only to a “consumer secured transaction” in the October 1996 draft.<sup>114</sup>

This subsection applies to a consumer secured transaction [and may not be varied by agreement]. If the extent to which a security interest is a purchase money security interest depends on the application of a payment to a particular obligation[, notwithstanding any contrary agreement,] the payment is to be applied first to obligations that are not secured and then, if more than one obligation is secured, to obligations secured by purchase money security interests in the order in which those obligations were incurred. [This subsection may not be varied by agreement.]<sup>115</sup>

This provision imposed a payment rule on the parties, and any agreement to the contrary would be invalid. Ostensibly, the proposed rule protected the consumer because any payment method included in the parties’ agreement, which would likely favor the secured party, would be invalid. It offered some consolation to the secured party because any unsecured debt would be paid first, leaving the collateral to secure

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<sup>113</sup> *Id.*

<sup>114</sup> UNIFORM COMMERCIAL CODE REVISED ARTICLE 9 at § 9-104(e) (Draft, Oct. 1996) [hereinafter “October 1996 NCCUSL Draft”], available at <http://www.law.upenn.edu/bll/archives/ulc/ucc9/m10draft.htm> (last visited Feb. 14, 2011). The reporters were Professors Charles W. Mooney, Jr. of the University of Pennsylvania and Steven L. Harris of the University of Illinois. The draft adopted a tentative definition of “consumer secured transaction” as a transaction in which an individual incurs an obligation for personal, family or household purposes secured by collateral used for personal, family or household purposes. *Id.* § 9-102(a)(8). The definition of “purchase-money security interest” moved from section 9-107 to section 9-104.

<sup>115</sup> *Id.* § 9-104(e). The brackets, present in the original, mean that the drafters had not reached a consensus. The draft retained the payments rule of the previous draft but made it expressly inapplicable to a “consumer secured transaction.” *Id.* § 9-104(d).

the remaining debt. However, no change was made to the dual status rule.<sup>116</sup> Purchase-money status continued regardless of refinancing or future advance.<sup>117</sup>

The reporter's minimal comments to the draft do not mention the change or the reason behind it. However, in the comments to the July 1997 NCCUSL draft, the drafting committee revealed its rationale for a separate payments rule for consumers: "The Drafting Committee thinks that freedom of contract with respect to allocation of payments is likely to be illusory in the consumer setting. Accordingly, it would adopt a statutory allocation rule that cannot be varied by agreement."<sup>118</sup>

Up to this point in the drafting of Revised Article 9, a dual status rule and a payment rule for all purchase-money security interests had been adopted in every draft. Perhaps the addition of the separate payments rule portended the future. In any event, that uniformity would change abruptly.

#### IV. THE "CONSUMER COMPROMISE" SHUTS THE DOOR ON DUAL STATUS FOR CONSUMER GOODS PURCHASE-MONEY SECURITY INTERESTS

Dual status and payment rules for consumer goods purchase-money security interests ended in the March 1998 draft for NCCUSL and the April 1998 draft for ALI.<sup>119</sup> Section 9-104 of both drafts continued dual status and payment rules for all purchase-money security interests except for "consumer-goods transactions."<sup>120</sup> In the ALI draft, the dual status and payment rules were prefaced with the phrase, "[i]n

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<sup>116</sup> *Id.* § 9-104 cmt. 3.

<sup>117</sup> *Id.* § 9-104(f).

<sup>118</sup> REVISION OF UNIFORM COMMERCIAL CODE ARTICLE 9 at § 9-104 cmt. 4 (Draft, July 1997) [hereinafter "July 1997 NCCUSL Draft"], available at <http://www.law.upenn.edu/bll/archives/ulc/ucc9/ucc997.htm> (last visited Feb. 14, 2011).

<sup>119</sup> REVISION OF UNIFORM COMMERCIAL CODE ARTICLE 9 at § 9-103(h) (Draft, Apr. 1998) [hereinafter "ALI Proposed Final Draft"], available at <http://www.law.upenn.edu/bll/archives/ulc/ucc9/98amdblk.htm> (last visited Feb. 8, 2011); REVISION OF UNIFORM COMMERCIAL CODE ARTICLE 9 at § 9-104 cmt. B (Draft, Mar. 1998) [hereinafter "March 1998 NCCUSL Draft"], available at <http://www.law.upenn.edu/bll/archives/ulc/ucc9/m14draft.htm>, (last visited Feb. 8, 2011).

<sup>120</sup> In both drafts, a "consumer-goods transaction" exists when an individual incurs an obligation for personal, family or household purposes that is secured by collateral used for personal, family or household purposes. See ALI Proposed Final Draft, *supra* note 119, at § 9-102(a)(16), 9-106; March 1998 NCCUSL Draft, *supra* note 119, at §§ 9-102(a) (16), 9-106.

a transaction other than a consumer-goods transaction,” thus disqualifying the rules from regulating a purchase-money security interest in consumer goods.<sup>121</sup> The NCCUSL draft included a section that had the same effect: “[s]ubsections (c), (d), and (e) do not apply to a consumer-goods transaction.”<sup>122</sup>

The changes were the result of the “Consumer Compromise” between consumer representatives, creditor representatives, the Consumer Issues Subcommittee, the drafting committee, and the sponsoring organizations.<sup>123</sup> The Consumer Issues Subcommittee had previously recommended dual status and payment rules for all purchase-money security interests.<sup>124</sup> The drafting committee, ALI, and NCCUSL accepted these recommendations at their 1996 annual meetings.<sup>125</sup> However, that was not the end of the story.

Professor Mooney notes that both consumer and creditor representatives were “somewhat dissatisfied with the draft of Revised Article 9 as approved in 1996.”<sup>126</sup> Professor Benfield observes that “[c]reditor representatives strongly objected to the pro-consumer provisions that were adopted by the National Conference and the ALI.”<sup>127</sup> That discontent fueled concern that legislative enactment of Revised Article 9 could be jeopardized,<sup>128</sup> and the concern led to a new undertaking to produce a set of consumer provisions that would be acceptable to both consumer and creditor representatives.<sup>129</sup> The product of the compromise was, as it related to consumer goods purchase-money security interests, no change to the

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<sup>121</sup> ALI Proposed Final Draft, *supra* note 119, at § 9-104(f), (g).

<sup>122</sup> March 1998 NCCUSL Draft, *supra* note 119, at § 9-104(f). Section 9-104, subsections (c), (d), and (e) were, respectively, the payment, dual status, and burden of proof rules.

<sup>123</sup> Marion W. Benfield, Jr., *Consumer Provisions in Revised Article 9*, 74 CHI.-KENT L. REV. 1255, 1258-59 (1999). Professor Benfield was the chair of the Consumer Issues Subcommittee and a member of the Drafting Committee. Credit for naming the compromise goes to Professor Charles W. Mooney, Jr. and his illuminating article discussing and critiquing the process and effects of the compromise. Mooney, *supra* note 31.

<sup>124</sup> *See supra* notes 80–89 and accompanying text.

<sup>125</sup> Benfield, *supra* note 123, at 1259.

<sup>126</sup> Mooney, *supra* note 31, at 218.

<sup>127</sup> Benfield, *supra* note 123, at 1259.

<sup>128</sup> *Id.*

<sup>129</sup> *Id.*

existing law. The compromise memorandum provided: “No codification of dual status or mixed collateral rule for consumers (keep current law).”<sup>130</sup> If success is measured by compromise and the eventual enactment of Revised Article 9, then the new undertaking was a great success. All fifty states adopted Revised Article 9, most by the target date of July 1, 2001.<sup>131</sup>

Success, however, does not necessarily equate with happiness.<sup>132</sup> Professor Benfield remarks that “[i]t is fair to say that neither group was happy with the proposals, but both believed that the proposals agreed to were such that neither group would oppose adoption of Revised Article 9 . . . .”<sup>133</sup> The Reporters’ Prefatory Comments to the ALI Proposed Final Draft note the shortcomings of the compromise: “The statutory text that has emerged is less than ideal in substance and approach. It represents a balance struck in the hope that it will enhance the opportunities for prompt and uniform enactment of revised Article 9.”<sup>134</sup> Professor Mooney is more critical of the compromise:

In particular, the near-term benefits of the rapid enactment of Revised Article 9 may be swamped by the longer-term costs of the compromise. These costs include the failure of Revised Article 9 to resolve important and controversial issues in consumer secured transactions and the inclusion of unwise and incoherent provisions.<sup>135</sup>

Regardless of any residual displeasure, the compromise held and is retained in section 9-103 of Revised Article 9.

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<sup>130</sup> Memorandum of Consumer and Creditor Understanding of Proposal on Consumer Issues, *reprinted in* Mooney, *supra* note 31, at 228. The compromise memorandum is reprinted in its entirety in Professor Mooney’s article.

<sup>131</sup> Mooney, *supra* note 31, at 215-16. The states that did not hit the target were Alabama, January 1, 2002; Connecticut, October 1, 2001; Florida, January 1, 2002; and Mississippi, January 1, 2002.

<sup>132</sup> See Jean Braucher, *Deadlock: Consumer Transactions Under Revised Article 9*, 73 AM. BANKR. L.J. 83, 116 (1999).

<sup>133</sup> Benfield, *supra* note 123, at 1259.

<sup>134</sup> REVISION OF UNIFORM COMMERCIAL CODE ARTICLE 9, REPORTERS’ PREFATORY COMMENTS at 4j, available at <http://www.law.upenn.edu/bll/archives/ulc/ucc9/am98pr.htm> (last visited Feb. 8, 2011). The complete comments of the reporters regarding consumer transactions appear in the ALI Proposed Final Draft, pages xlv-vii, and a less complete version in the March 1998 NCCUSL Draft, Reporters’ Prefatory Note.

<sup>135</sup> Mooney, *supra* note 31, at 216.

The compromise also produced an accompanying change to clarify the drafters' intent regarding the effect of the limitation on a consumer goods purchase-money security interest. Section 9-104(i) of the ALI Proposed Final Draft admonished courts to draw no inference from the limitation of the dual status and payment rules to purchase-money security interests other than consumer-goods transactions:

The limitation of the rules . . . to transactions other than consumer-goods transactions is intended to leave to the court the determination of the proper rules in consumer-goods transactions. The court may not draw from that limitation an inference as to the nature of the proper rule in consumer-goods transactions, and the court may continue to apply established approaches.<sup>136</sup>

The NCCUSL draft suggested that a similar statement should be added to the Official Comment for the section.<sup>137</sup> The ALI prevailed, and that statement now appears in current section 9-103(h). Consequently, determining the effect of a refinancing or a future advance on a consumer goods purchase-money security interest in the twenty-first century was essentially left to the same rules that existed in the 1962 Official Text of Article 9.<sup>138</sup>

## V. THE CASE FOR ADOPTING DUAL STATUS UNDER REVISED ARTICLE 9

In most states the courts must settle the issue of whether a consumer goods purchase-money security interest retains purchase-money status after the secured party makes a future advance or refinances the purchase-money obligation.<sup>139</sup> The starting point for most courts will be the purchase-money security interest definition in section 9-103, regardless that the dual status and payment rules of section 9-103 are inapplicable to consumer-goods transactions. The purchase-money security interest definition in sections 9-103(a) and (b) applies to all security interests. I assert

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<sup>136</sup> ALI Proposed Final Draft, *supra* note 119, at § 9-104(i), available at <http://www.law.upenn.edu/bll/archives/ulc/ucc9/ucc9amg.htm> (last visited Feb. 8, 2011).

<sup>137</sup> March 1998 NCCUSL Draft, *supra* note 119, at § 9-104 cmt. A.

<sup>138</sup> Braucher, *supra* note 132 at, 97-98. Professor Braucher labels the failure of the drafters to resolve this issue as “we punt.” *Id.*

<sup>139</sup> Nine states have settled this issue with legislation that amends section 9-103 to apply the dual status and payment rules to purchase-money security interests in consumer goods. *See infra* Part VII.

that the purchase-money definition compels the result that a consumer goods transaction can be part purchase-money and part nonpurchase-money under that definition.

The definition of purchase-money security interest has three aspects: the definition of purchase-money security interest, the definition of purchase-money collateral, and the definition of purchase-money obligation. A security interest in goods is a purchase-money security interest “to the extent that the goods are purchase-money collateral with respect to that security interest.”<sup>140</sup> Collateral is purchase-money collateral when it is connected to a purchase-money obligation.<sup>141</sup> “[P]urchase-money collateral means goods or software that secures a purchase-money obligation incurred with respect to that collateral.”<sup>142</sup> An obligation is purchase-money when it is connected to obtaining the collateral.<sup>143</sup> “[P]urchase-money obligation means an obligation of an obligor incurred as all or part of the price of the collateral or for value given to enable the debtor to acquire rights in or the use of the collateral if the value is in fact so used.”<sup>144</sup> In simple terms, a purchase-money security interest exists when the secured party loans the debtor (by installment sale or actual loan) the purchase price of the collateral and the debtor grants a security interest in the collateral purchased to secure the loan.<sup>145</sup>

To illustrate these definitions, assume that a lender loans money to an individual to enable her to purchase a television for personal use. The individual grants the lender a security interest in the television to secure the loan. From its inception, the loan to purchase the television is a purchase-money obligation: the individual received “value” from the secured party that enabled her to acquire the

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<sup>140</sup> U.C.C. § 9-103(b)(1).

<sup>141</sup> § 9-103(a)(1).

<sup>142</sup> *Id.*

<sup>143</sup> § 9-103(a)(2).

<sup>144</sup> *Id.* The two-part definition of purchase-money obligation allows a seller of the collateral (“price of the collateral”) or a lender that advances the purchase-money (“value given to enable the debtor to acquire rights in ... the collateral”) to obtain a purchase-money security interest. *Id.*

<sup>145</sup> The debtor and the obligor can be different persons. *See* U.C.C. § 9-102(a)(28), (59). For example, a purchase-money security interest exists when mother (obligor) borrows money from a bank to purchase a car that will be owned by daughter (debtor) and daughter grants the bank a security interest in the car to secure the loan.

television.<sup>146</sup> Similarly, the television is purchase-money collateral. It is a good that secures the money loaned to enable the individual to purchase the collateral—“a purchase-money obligation incurred with respect to that collateral.”<sup>147</sup> The security interest is completely purchase-money because the only collateral, the television, is purchase-money collateral and the only obligation, the television loan, is a purchase-money obligation.<sup>148</sup>

Does the purchase-money security interest continue after the secured party agrees to make the debtor another loan and secures that loan with the television?<sup>149</sup> It should, because “to the extent” in section 9-103(b)(1) permits the security interest to be a partial purchase-money security interest. The television continues to secure the loan made to purchase it regardless of the future advance. That the television also secures the future advance does not affect its status as securing the loan made to purchase the television.<sup>150</sup> It remains purchase-money collateral because it secures a purchase-money obligation, and to that extent the security interest is purchase-money.<sup>151</sup> The security interest that exists after the secured party makes a future advance precisely fits “to the extent” of section 9-103(b). No other interpretation of the words “to the extent” gives them an appropriate meaning.

The committees that studied the revision of Article 9 would concur in that interpretation. The PEB Study Committee, commenting on the proposed addition of an express dual status rule, noted that the rule “would yield the results that obtain under a proper application of current law.”<sup>152</sup> The Consumer Issues Subcommittee stated that “to the extent” in section 9-107 “provides a strong argument that the

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<sup>146</sup> See U.C.C. § 9-103(a)(2).

<sup>147</sup> See § 9-103(a)(1).

<sup>148</sup> See § 9-103(b)(1).

<sup>149</sup> The additional loan is a future advance under U.C.C. § 9-204(c). Because most security agreements, purchase-money or otherwise, include a future advance clause, the existing collateral serves as collateral for the new loan without the debtor executing another security agreement. *See id.*

<sup>150</sup> The priority rules of Article 9 (U.C.C. §§ 9-317 to 9-339, primarily U.C.C. § 9-322(a)) would determine the priority of the security interest for the future advance.

<sup>151</sup> U.C.C. § 9-103(b)(1).

<sup>152</sup> PEB REPORT, *supra* note 26, at 98.

drafters contemplated that a debt might be partly purchase money and partly non-purchase money.”<sup>153</sup> The opinions of academics reached the same conclusion.<sup>154</sup>

All those sources were commenting on section 9-107. Although the basic purchase-money definition was not changed, sections 9-103(e) and (f) disqualify the dual status and payment rules from applying to a consumer-goods transaction.<sup>155</sup> Those limitations raise the question of whether “to the extent” in section 9-103(b) should apply in determining whether a consumer-goods purchase-money security interest remains purchase-money after a future advance or a refinancing.

“To the extent” should apply to determine whether a consumer goods security interest is a purchase-money security interest. The scope limitations in section 9-103 appear only in sections 9-103(e), (f), and (g).<sup>156</sup> Those sections pertain to, respectively, payments, dual status, and burden of proof. Sections 9-103(a) and (b), the purchase-money security interest definition sections, include no such limitation, and they should apply to all security interests unless some other limitation exists. Section 9-103(h) comments on the limitation, but does not enlarge it. It simply expresses the drafters’ intention that courts must resolve issues of payment and dual status, drawing no inference from the limitations.<sup>157</sup> Section (h) makes no statement that subsections (a) and (b) are inapplicable to deciding the issue of purchase-money status for a consumer-goods security interest. The collective effect

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<sup>153</sup> CONSUMER ISSUES SUBCOMMITTEE REPORT, *supra* note 102, at 341..

<sup>154</sup> See Mary Aronov, *The Transformation Rule Applied to Purchase Money Security Interests in Commercial Lending Transactions*, 16 MEM. ST. U. L. REV. 15, 42 (1985); Bernard A. Burk, *Preserving the Purchase Money Status of Refinanced or Commingled Purchase Money Debt*, 35 STAN. L. REV. 1133, 1157-58 (1983); Robert M. Lloyd, *Refinancing Purchase Money Security Interests*, 53 TENN. L. REV. 1, 64 (1985); Gerald T. McLaughlin, *“Add On” Clauses in Equipment Purchase Money Financing: Too Much of a Good Thing*, 49 FORDHAM L. REV. 661, 680 (1981); Ann E. Conaway Stilson, *The “Overloaded” PMSI in Bankruptcy: A Problem in Search of a Resolution*, 60 TEMP. L.Q. 1, 36 (1987).

<sup>155</sup> U.C.C. § 9-103(e), (f).

<sup>156</sup> The rule of U.C.C. § 9-103(g), which places the burden of proving the extent to which a security interest is purchase-money on the secured party, is limited to “a transaction other than a consumer-goods transaction.”

<sup>157</sup> “The limitation of the rules in subsections (e), (f), and (g) to transactions other than consumer-goods transactions is intended to leave to the court the determination of the proper rules in consumer-goods transactions. The court may not infer from that limitation the nature of the proper rule in consumer-goods transactions and may continue to apply established approaches.” U.C.C. § 9-103(h).

of those sections causes the definition in subsections 9-103(a) and (b) to govern all security interests.

Courts have the responsibility of determining the proper rule to apply when deciding the issue, but they nevertheless are bound by the purchase-money definition in section 9-103. They must apply the statutory definition to the transaction.<sup>158</sup> A proper application yields a dual status purchase-money security interest because a security interest can be purchase-money “to the extent that the goods are purchase-money collateral with respect to that security interest.”<sup>159</sup> A security interest in consumer goods that begins as a purchase-money security interest remains purchase-money to the extent of the purchase-money obligation but is nonpurchase-money to the extent of the future advance.<sup>160</sup> That result fits the definition.

A refinancing or renewal of a purchase-money security interest obligation also raises the issue of whether a security interest remains purchase-money.<sup>161</sup> Those transactions take various forms, from simply extending the repayment period of the loan to canceling the original obligation and replacing it with a new obligation and security agreement.<sup>162</sup> Consequently, they do not engage the dual status rule literally because the obligation created is based entirely on the purchase-money transaction.<sup>163</sup> If the secured obligation is purchase-money only, dual status is not an issue. Nevertheless, most courts facing the issue refer to “dual status” in their analysis, and I will do likewise. Because Article 9 treats refinancing, renewal, restructuring, and

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<sup>158</sup> See generally *In re Geist*, 79 B.R. 939 (D. Wyo. 1987) (rejecting the transformation rule because it conflicts with U.C.C. language).

<sup>159</sup> U.C.C. § 9-103(b)(1). The drafters recognize that courts “have found this rule to be explicit or implicit in the words ‘to the extent.’” *Id.* § 9-103 cmt. 7a.

<sup>160</sup> See Part VI for discussion of the effect on the security interest of a payment.

<sup>161</sup> The dual status rule of section 9-103(f)(3) treats refinancing, renewal, restructuring, and consolidation the same way—the security interest remains purchase-money after that event. Article 9 does not define those terms. See *supra* notes 2 and 3. Official Comment 7.b explains that whether a security interest transaction comes within those terms, and thus the security interest remains purchase-money, depends on whether “the purchase-money character of the security interest fairly can be said to survive.” U.C.C. § 9-103 cmt. 7b.

<sup>162</sup> See, e.g., *In re Short*, 170 B.R. 128, 134 (Bankr. S.D. Ill. 1994).

<sup>163</sup> That assumes no future advance accompanies the refinancing. Frequently, however, an additional loan is made with the refinancing or the purchase-money loan is consolidated with a non-purchase-money loan. Such transactions clearly raise the dual status issue.

consolidation the same, I will refer only to “refinancing” when discussing these transactions.<sup>164</sup>

Courts holding that a refinancing destroys the purchase-money status of a security interest typically rely on the statutory requirement that the collateral must secure the debt that was incurred to purchase the collateral.<sup>165</sup> In most refinancing situations, a new debt replaces the previous purchase-money debt, and the purchase-money collateral secures the new debt. Thus, a court can find that purchase-money collateral secures an obligation that is no longer a literal purchase-money obligation; consequently, the transaction no longer satisfies the purchase-money security interest definition.

But does that result exalt form over substance?<sup>166</sup> Judge Dietz, in *In re Conn*, argues that it does:

Though in form the original note is cancelled, its balance is absorbed into the refinancing loan. To the extent of that balance, the purchase money security interest taken under the original note likewise survives, because what is owed on the original note is not eliminated, it is merely transferred to . . . another obligation. The refinancing changes the character of neither the balance due under the first loan nor the security interest taken under it.<sup>167</sup>

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<sup>164</sup> Note that none of those transactions results in the loss of purchase-money status under the rule of U.C.C. § 9-103(f)(3).

<sup>165</sup> U.C.C. § 9-103(a), (b)(1); U.C.C. § 9-107(b) (1995). See generally *In re Matthews*, 724 F.2d 798 (9th Cir. 1984); *In re Keeton*, 161 B.R. 410 (Bankr. S.D. Ohio 1993); *In re Hipps*, 89 B.R. 264 (Bankr. N.D. Ga. 1988); *In re Faughn*, 69 B.R. 18, (Bankr. E.D. Mo. 1986); *In re Jones*, 5 B.R. 655, 657 (Bankr. M.D.N.C. 1980). Official Comment 2 to section 9-107 of former Article 9 noted that the purchase-money definition “excludes from the purchase money category any security interest taken as security for or in satisfaction of a preexisting claim or antecedent debt.” Although the Official Comment to section 9-103 does not include that statement, the definition of purchase-money security interest in section 9-103 creates that requirement.

<sup>166</sup> See *In re Geist*, 79 B.R. 939, 942 (D. Wyo. 1987); Carlson, *supra* note 17, at 851.

<sup>167</sup> *In re Conn*, 16 B.R. 454, 459 (Bankr. W.D. Ky. 1982). In *Conn*, the borrower also received an additional \$700 in the refinancing transaction. *Id.* at 455. Cf. *In re Geist*, 79 B.R. 939, 942 (D. Wyo. 1987); *In re Richardson*, 47 B.R. 113, 117 (Bankr. W.D. Wis. 1985); *In re Russell*, 29 B.R. 270, 273 (Bankr. W.D. Okla. 1983); *In re Stevens*, 24 B.R. 536, 538 (Bankr. D. Colo. 1982).

His reasoning is sound. If the transaction was born as a purchase-money security interest, then the initial obligation is also purchase-money. The purchase-money obligation has a balance due when the final payment day arrives. If the parties agree to refinance the outstanding balance and secure the resulting debt with a security interest in the purchase-money collateral, technically the new debt is not a “purchase-money obligation” because it does not enable the debtor to obtain the collateral; the debtor already has the collateral when the initial loan is refinanced.<sup>168</sup> In substance, however, the debt is the same indebtedness that enabled the debtor to obtain the collateral: a purchase-money obligation.<sup>169</sup> That the new debt might carry a different due date or interest rate should not obscure the fact that it is still the purchase-money debt.<sup>170</sup> Though the debt wears a different label, it is nonetheless the same debt underneath. It is the debt for the purchase-money of the collateral. To hold otherwise puts form above substance.

A valid inquiry for determining whether the refinanced debt remains purchase-money is whether “the purchase-money character of the security interest fairly can be said to survive.”<sup>171</sup> In allowing a refinanced loan to remain purchase-money, the drafters of Revised Article 9 base that status on whether “an identifiable portion of the purchase-money obligation could be traced to the new obligation . . . .”<sup>172</sup> That tracing is not complicated. For example, if a debtor refinances a purchase-money obligation that has a balance of \$1000, then \$1000 of the new obligation is purchase-money regardless of the total amount of the new obligation. In fact, it is difficult to conceive of a situation in which the purchase-money obligation is not identifiable in the new obligation. The purchase-money character survives and the security interest should remain purchase-money.

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<sup>168</sup> “[P]urchase-money obligation’ means an obligation of an obligor incurred as all or part of the price of the collateral or for value given to enable the debtor to acquire rights in or the use of the collateral if the value is in fact so used.” U.C.C. § 9-103(a)(2).

<sup>169</sup> *Accord In re Fickey*, 23 B.R. 586, 590 (Bankr. E.D. Tenn. 1982) (refinancing carried out in form of new loan does not mean the new loan is completely nonpurchase-money).

<sup>170</sup> *In re Billings*, 838 F.2d 405, 408 n.4 (10th Cir. 1988) (change in interest rate on renewal of debt did not require finding the original obligation is extinguished); *In re Littlejohn*, 20 B.R. 695, 698 (Bankr. W.D. Ky. 1982) (higher interest rate for refinanced loan does not make loan nonpurchase-money).

<sup>171</sup> U.C.C. § 9-103 cmt. 7b.

<sup>172</sup> *Id.* While the drafters are commenting on the dual status rule as it applies to purchase-money security interests other than consumer-goods transactions, the tracing principle is nevertheless applicable to a consumer goods purchase-money security interest.

*A. Is a Refinancing a Novation?*

There is the assertion that a refinanced loan creates a novation.<sup>173</sup> Black's Law Dictionary defines novation as the "act of substituting for an old obligation a new one that either replaces an existing obligation with a new obligation or replaces an original party with a new party."<sup>174</sup> A novation of a purchase-money obligation could arguably occur when the parties terminate the purchase-money loan and replace it with a new obligation because the obligation is no longer purchase-money security. The question is whether a novation results automatically from a refinancing or only when the parties intend to extinguish the old obligation and replace it with a new obligation.<sup>175</sup> Some courts have found an "automatic" novation, but other courts look for evidence of the parties' intent to terminate and replace the purchase-money obligation.<sup>176</sup>

Although a refinancing transaction typically produces a new promissory note or installment contract and perhaps even a new security agreement, it seems unlikely that the parties, especially the secured creditor, intend to terminate the purchase-money status of the obligation and replace it with a nonpurchase-money obligation.<sup>177</sup> A secured creditor agreeing to that would be giving up the advantages of having a purchase-money security interest simply by agreeing to refinance an existing obligation. There is no benefit to the secured party for agreeing to refinance a purchase-money loan, other than perhaps a higher rate of interest on the refinanced obligation.<sup>178</sup> And except in bankruptcy, replacing the purchase-money

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<sup>173</sup> See *In re Schwartz*, 52 B.R. 314, 315-16 (Bankr. E.D. Pa. 1985); *In re Richardson*, 47 B.R. 113, 117, (Bankr. W.D. Wis. 1985); Carlson, *supra* note 17, at 848-49; Lloyd, *supra* note 154, at 56-63.

<sup>174</sup> BLACK'S LAW DICTIONARY 1094 (7th ed. 1999).

<sup>175</sup> Lloyd, *supra* note 154, at 59-60.

<sup>176</sup> Compare *In re Jones*, 5 B.R. 655, 657 (Bankr. M.D.N.C. 1980), and *In re Matthews*, 724 F.2d 798, 800 (9th Cir. 1984), with *In re Cantrill Constr. Co.*, 418 F.2d 705, 706-07 (6th Cir. 1969), *In re Johnson*, 15 B.R. 681, 684-85 (Bankr. W.D. Mo. 1981), and *Wells Fargo Fin. Ky., Inc. v. Thomer*, 315 S.W.3d 335, 338-39 (Ky. Ct. App. 2010).

<sup>177</sup> See Carlson, *supra* note 17, at 850-52. Because most security agreements include a future advance clause, there is no need to have the debtor authenticate a new security agreement. The new obligation is secured by the purchase-money collateral pursuant to the future advance clause. U.C.C. § 9-204(c). A new security agreement is needed if the secured party adds collateral to the security interest.

<sup>178</sup> If the obligor is in default on the obligation, the refinancing creates the opportunity that the obligor might be able to pay the debt with the extension of time. Repayment of the debt of course

obligation with a nonpurchase-money obligation provides no benefit to the debtor.<sup>179</sup> Consequently, although a refinancing transaction might produce a new “form” of obligation, there is no reason to assume that the parties have agreed that the replacement of the debt in form operates as a substantive termination and replacement of the purchase-money debt.<sup>180</sup> Because a novation that ends purchase-money status can have drastic consequences for a secured creditor, a refinancing should not produce a novation unless the parties clearly indicate that intent.<sup>181</sup>

*B. Policy Considerations of Dual Status*

If dual status is to be the prevailing rule for consumer goods purchase-money security interests, it should comport with the policy for the special privileges awarded to a purchase-money security interest and should not harm the debtor or other creditors. Section 9-324(a) of Article 9 grants a purchase-money security interest priority over security interests perfected earlier in time.<sup>182</sup> Priority is justified because the credit the purchase-money secured party gives increases the debtor’s assets by the value of the purchase-money collateral.<sup>183</sup> If a future advance or a refinancing ends purchase-money status, the previously superior purchase-money security interest could become a subordinate nonpurchase-money security interest.<sup>184</sup> If

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benefits the secured party. Refinancing of a debt in default also allows the secured party to delay implementing the Article 9 remedies against the collateral and the obligor.

<sup>179</sup> As noted previously, a debtor who files a Chapter 7 bankruptcy can avoid a nonpurchase-money security interest in specified consumer goods under 11 U.S.C. § 522(f).

<sup>180</sup> See *In re Conn*, 16 B.R. 454, 459-60 (Bankr. W.D. Ky. 1982).

<sup>181</sup> See *In re Janz*, 67 B.R. 553, 556 (Bankr. D.N.D. 1986); *In re Richardson*, 47 B.R. 113, 117 (Bankr. W.D. Wis. 1985); *Lewiston State Bank v. Greenline Equip., L.L.C.*, 147 P.3d 951, 955 (Utah Ct. App. 2006); see also *supra* pp. 2-3.

<sup>182</sup> U.C.C. § 9-324(a) awards a perfected purchase-money security interest in goods other than livestock or inventory (thus including consumer goods) priority over other perfected security interests in the same collateral or the proceeds of the collateral. The “other” security interest involved in a priority conflict is a security interest that covers after-acquired collateral. Because U.C.C. § 9-204(b)(1) limits the life of an after-acquired property clause in consumer goods, other than accessions, to goods the debtor acquires within ten days of attachment of the security interest, the number of secured creditors affected by a dual status purchase-money security interest is not large.

<sup>183</sup> Carlson, *supra* note 17, at 794.

<sup>184</sup> U.C.C. § 9-322(a) governs priority between conflicting security interests in the same collateral when no specific priority rule applies. It awards priority to the security interest that has the earlier

purchase-money status is maintained, the priority of the purchase-money part of the security interest does not change. That is not an unjust outcome; it is the intended priority scheme of Article 9. The purchase-money secured party has committed no act that justifies loss of priority in the purchase-money collateral for the purchase-money obligation. Moreover, the purchase-money priority does not extend to the nonpurchase-money obligation. Priority for that obligation will be determined by the applicable Article 9 priority rule, generally section 9-322.<sup>185</sup>

Another special benefit awarded to a consumer goods purchase-money security interest is perfection without filing a financing statement or taking other action.<sup>186</sup> This privilege allows a seller or lender that takes a purchase-money security interest in consumer goods to have a perfected security interest upon satisfying the attachment requirements.<sup>187</sup> If a secured party elects to perfect in this manner, the security interest becomes unperfected if its status changes from purchase-money to nonpurchase-money.<sup>188</sup> That has drastic consequences in bankruptcy—a trustee in bankruptcy can avoid an unperfected security interest—or when another perfected secured party claims an interest in the collateral—perfected security interest has priority over an unperfected security interest.<sup>189</sup> A secured party with a purchase-money security interest does not contemplate loss of its purchase-money status when it refinances a debt or makes a future advance and thus likely would not recognize the need to take action to perfect its security interest.<sup>190</sup> Nor has the secured party

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perfection or filing date. U.C.C. § 9-322(a)(1). Usually, the conflicting security interest would have the earlier priority date.

<sup>185</sup> U.C.C. § 9-322.

<sup>186</sup> U.C.C. § 9-309(1) grants perfection upon attachment for a purchase-money security interest in consumer goods except for goods subject to a statute or treaty as described in U.C.C. 9-311. Typically, the goods covered by section 9-311 are motor vehicles, so usually there is no perfection upon attachment for a purchase-money security interest in a consumer good motor vehicle.

<sup>187</sup> Attachment of a security interest requires that the secured party give value to the debtor, the debtor has rights in the collateral, and, generally, the debtor authenticates a security agreement describing the collateral. U.C.C. § 9-203(a), (b). A secured party can file a financing statement if it desires, and that filing would prevent a buyer of the collateral from taking free of the security interest under U.C.C. § 9-320(b).

<sup>188</sup> *See* U.C.C. § 9-309 cmt. 3.

<sup>189</sup> 11 U.S.C. § 544(a)(1) (2010); U.C.C. § 9-322(a).

<sup>190</sup> If there is a nonpurchase-money part of the security interest, such as a future advance, then the secured party must take action to perfect that part.

committed any act that justifies loss of perfection. The drafters wanted automatic perfection for an attached purchase-money security interest in consumer goods.<sup>191</sup> Loss of purchase-money status is contrary to that policy.

Allowing continuation of purchase-money status after refinancing or making a future advance causes no unexpected harm to the debtor. The debtor and secured party intended a purchase-money security interest from the inception of their relationship.<sup>192</sup> Although the advantages of a purchase-money security interest benefit the secured party, they do not detriment the debtor. Initially, the debtor seemingly has little interest in the type of security interest because the obligation is the same regardless of the type. The debtor is interested in obtaining the collateral. Only in the event of bankruptcy does the debtor become interested in whether the security interest is purchase-money. That is because the avoidance power of Bankruptcy Code section 522(f) applies only to a nonpurchase-money security interest. Consequently, the debtor may assert that refinancing or making a future advance ends purchase-money status. Ironically, the very acts that create the transformation argument are sought by and benefit the debtor.<sup>193</sup> The debtor seeks refinancing or a future advance to aid in paying the debt or in receiving additional funds, not for the purpose of gaining a nonpurchase-money security interest.<sup>194</sup> Maintaining the purchase-money status does not damage the expectations of the debtor and thus does not cause the debtor unexpected harm.

Retaining purchase-money status of a purchase-money security interest in consumer goods does not thwart the intent of Congress in enacting Bankruptcy Code section 522(f). The Bankruptcy Code permits a valid security interest to trump

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<sup>191</sup> The reason expressed by the drafters for such perfection is that, prior to adoption of the UCC, many states did not implement filing requirements for consumer goods under conditional sales or bailment leases. U.C.C. § 9-302 cmt. 4. (1962). Perfection without filing for a purchase-money security interest in consumer goods has always been the rule of Article 9. *See* U.C.C. §§ 9-302(1)(d) (1962), 9-302(1)(d) (1995), 9-309(1) (2005).

<sup>192</sup> The parties' debtor-creditor relationship could predate the purchase-money transaction if an existing debt is consolidated with the purchase-money obligation into a single debt. *See* *Coomer v. Barclays Am. Fin., Inc.*, 8 B.R. 351, 353-54 (Bankr. E.D. Tenn. 1980)..

<sup>193</sup> One can assert logically that the secured party also benefits from those acts—more interest is likely paid because of the additional repayment time of a refinancing or increased debt of a future advance.

<sup>194</sup> *See In re Cantrill Constr. Co.*, 418 F.2d 705, 707 (6th Cir. 1969).

a debtor's exemption in the collateral.<sup>195</sup> Congress intended for section (f) to preserve the Bankruptcy Code's grant of exempt property for individual debtors.<sup>196</sup> Their concern emanated from findings that creditors lending money to consumers frequently took a security interest in all of the debtor's belongings and then threatened repossession of those goods if the debtor defaulted.<sup>197</sup> To remedy that situation Congress proposed allowing a debtor to avoid a nonpossessory, nonpurchase-money security interest in specified consumer goods to the extent that a security interest impairs an exemption. Section (f) has never authorized avoidance of a purchase-money security interest. Purchase-money creditors do not have the same motives as creditors with a blanket security interest in consumer goods.<sup>198</sup> Purchase-money creditors take a security interest in the goods they enable the debtor to acquire.<sup>199</sup> They do not threaten repossession of all the debtor's household goods.<sup>200</sup> Maintaining the purchase-money status of a purchase-money security interest in consumer goods after a future advance or a refinancing is consistent with the intent of section 522(f).

Lastly, the judicial conversion of a purchase-money security interest to a nonpurchase-money security interest could result in eventual harm to consumer debtors. Presumably, a debtor who seeks a future advance or a refinancing has need for such credit. An existing purchase-money secured party might be willing to extend the needed credit. If, however, those transactions result in loss of purchase-money status, the secured party will eventually cease agreeing to extend such credit.<sup>201</sup> Loss of purchase-money status could lead to higher costs for creditors and might even lead a creditor to forego making purchase-money loans completely.<sup>202</sup>

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<sup>195</sup> 11 U.S.C. § 522(c)(2) (2010).

<sup>196</sup> H.R. REP. NO. 95-595, at 4 (1977).

<sup>197</sup> *Id.*

<sup>198</sup> The adoption of Federal Trade Commission regulations, subsequent to the enactment of the Bankruptcy Code, prevents the potential injustice of a blanket security interest in consumer goods. 16 C.F.R. 433.1 (2011).

<sup>199</sup> *See In re Matthews*, 724 F.2d 798, 799 (9th Cir. 1984).

<sup>200</sup> *See id.*

<sup>201</sup> Lloyd, *supra* note 154, at 10.

<sup>202</sup> *See Benfield*, *supra* note 123, at 1296; Christopher Harry, *To Be (Transformed) or Not To Be: The Transformation Versus Dual-Status Rules for Purchase-Money Security Interests Under Kansas' Former and Revised Article 9*, 50 U. KAN. L. REV. 1095, 1132 (2002); Lloyd, *supra* note 154, at 10.

Perhaps the debtor can obtain the credit from another creditor, but a new creditor generates transaction costs borne by the debtor, including additional time spent, credit checks, and document fees. Many debtors rely on purchase-money financing to enable them to purchase higher-cost consumer goods. Increased cost or loss of credit is not a favorable outcome for consumers.

Allowing a consumer goods purchase-money security interest to be dual status is clearly warranted by the purchase-money definition of sections 9-103(a) and (b)(1). It is consistent with the intent of the debtor, the secured party, and the drafters. It does not harm the debtor or other creditors. And if dual status is not allowed, consumer debtors may suffer increased cost or the loss of credit.

## VI. APPLICATION OF PAYMENTS

Even courts that accept dual status struggle with the effect of a payment.<sup>203</sup> After the debtor makes a payment on a debt secured by a dual status purchase-money security interest, it can be difficult to determine which part of the remaining obligation is purchase-money and which part is nonpurchase-money.<sup>204</sup> When a court is unable or unwilling to ascertain the amount of each part, the result is that the security interest loses its dual status and becomes a nonpurchase-money security interest.<sup>205</sup> The payment rules of section 9-103(e) in Revised Article 9 are expressly inapplicable to consumer goods purchase-money security interests.<sup>206</sup> That leaves the

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<sup>203</sup> Southtrust Bank of Ala., Nat'l Ass'n. v. Borg-Warner Acceptance Corp., 760 F.2d 1240, 1243. (11th Cir. 1985); *In re Bray*, 365 B.R. 850, 859 (Bankr. W.D. Tenn. 2007); *Coomer v. Barclays Am. Fin., Inc.*, 8 B.R. 351, 354 (Bankr. E.D. Tenn. 1980); *First Nat'l Bank of Steeleville, N.A. v. Erb Equip. Co.*, 921 S.W.2d 57, 63 (Mo. Ct. App. 1996).

<sup>204</sup> *See Coomer*, 8 B.R. at 353. The task for the court is much easier if the parties have agreed on an application method. The Consumer Issues Subcommittee noted in its May 1996 report that "[w]e are told that currently, most consumer purchase money contracts provide a method of allocation of payments after a consolidation or refinancing, so that the apportionment problem rationale for denying 'dual status' has largely disappeared." CONSUMER ISSUES SUBCOMMITTEE REPORT, *supra* note 102, at 341. The number of cases today that involve this issue indicate that many agreements still do not include such clauses.

<sup>205</sup> "Without some guidelines, legislative or contractual, the court should not be required to distill from a mass of transactions the extent to which a security interest is purchase money." *Coomer*, 8 B.R. at 355.

<sup>206</sup> "In a transaction other than a consumer-goods transaction, . . . the payment must be applied . . ." U.C.C. § 9-103(e).

issue for the courts.<sup>207</sup> To implement the dual status rule that I advocate in Part V, courts must accept the task of allocating payments between the parts of the security interest. The burden is not insurmountable.

Before exploring possible solutions, a basic example will illustrate the issue. Assume the Seller sells the Debtor a consumer-goods computer through an installment sales agreement and takes a security interest in the computer to secure its price, \$2200.<sup>208</sup> The Seller assigns the purchase-money security interest to Finance Company.<sup>209</sup> After the Debtor has paid \$500 of the obligation, Finance Company loans the Debtor \$1000 under the future advance clause of the installment sales agreement. After the future advance, the purchase-money collateral secures the \$1000 nonpurchase-money debt as well as the \$1700 purchase-money debt.<sup>210</sup> Applying the dual status rule, the security interest is purchase-money to the extent of \$1700 and nonpurchase-money to the extent of \$1000. The difficult issue arises when the Debtor makes a payment on the indebtedness. What part of the debt is purchase-money and what part is nonpurchase-money?

Perhaps the simplest solution to this problem is for a court to judicially adopt the payment rules of section 9-103(e). Section 9-103(e) adopts three hierarchical rules to use for determining which part of a security interest is purchase-money and which part is nonpurchase-money. First, if the parties have agreed to a “reasonable method” of applying payments, a court must abide by the agreement.<sup>211</sup> Note that a

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<sup>207</sup> “The limitation of the rules in subsections (e), (f), and (g) to transactions other than consumer-goods transactions is intended to leave to the court the determination of the proper rules in consumer-goods transactions.” U.C.C. § 9-103(h).

<sup>208</sup> The installment sales agreement includes the loan obligation and constitutes the security agreement. It functions the same as a security agreement that is separate from the documentation of the loan obligation.

<sup>209</sup> Assignment of the purchase-money obligation to a third party creditor should not cause the security interest to become nonpurchase-money. *In re Penrod*, 392 B.R. 835, 838 n. 3 (B.A.P. 9th Cir. 2008); *In re Trejos*, 374 B.R. 210, 215-17 (B.A.P. 9th Cir. 2007); *In re Cole*, No. 02-06385-DH, 2003 WL 25932189, at \*10 (Bankr. S.D. Iowa Dec. 27, 2003); *In re Brooks*, 74 B.R. 418, 419 (Bankr. N.D. Ga. 1987); *cf.* U.C.C. § 9-310(c) cmt. 4.

<sup>210</sup> When a security agreement includes a future advance clause, the collateral described in the security agreement secures all obligations arising thereunder. U.C.C. § 9-204(c).

<sup>211</sup> U.C.C. § 9-103(e)(1).

court is compelled to implement the agreement only if it is reasonable.<sup>212</sup> Second, if no such agreement exists, a court must apply payments pursuant to the intention of the obligor, whether manifested at the time of payment or before.<sup>213</sup> This allows the obligor to decide how to allocate the payments between purchase-money and nonpurchase-money parts. Each of these rules requires that the court make a factual inquiry into whether the parties have agreed to a reasonable method or whether the obligor has manifested an intention. Third, in the absence of agreement or intention, the court applies payments first to unsecured obligations, if any, and next to purchase-money obligations in the order of their occurrence.<sup>214</sup> Any nonpurchase-money secured obligation is paid last. Thus, in the typical dual status security interest, payments would be applied first to the purchase-money part and next to the nonpurchase-money part. The factual inquiry of this rule is simply to determine the amounts of the component parts and the amounts of any payments. This inquiry seems the least burdensome on the court.

A court is not restricted from judicially adopting the Article 9 payment rules. The UCC drafters expressly ceded the authority to the court to decide the appropriate rules for consumer goods purchase-money security interests.<sup>215</sup> A court could exercise its authority by utilizing the section 9-103(e) rules.<sup>216</sup> A state legislature's choice to follow uniform Revised Article 9 and limit the payment rules to purchase-money security interests other than consumer-goods transactions does not preclude the court from implementing them judicially as the rule of law for the

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<sup>212</sup> Official Comment 7.b observes that an "unconscionable method of application . . . is not a reasonable one and so would not be given effect under subsection (e)(1)." U.C.C. § 9-103 cmt 7b.

<sup>213</sup> U.C.C. § 9-103(e)(2).

<sup>214</sup> § 9-103(e)(3). Official Comment 7b notes that, if the transaction includes more than one purchase-money security interest, payments are applied to the purchase-money obligations first incurred. With the increasing use of "dragnet" obligation clauses in which the security interest covers any indebtedness regardless of type or time, there is small likelihood that the debtor would owe the creditor an unsecured obligation.

<sup>215</sup> § 9-103(h).

<sup>216</sup> Moreover, a court could decide to adopt only the rule of section 9-103(e)(3) that applies payments first to unsecured obligations and then to purchase-money obligations in their order of occurrence. This would limit the court's involvement in investigating the facts of the transaction because the only inquiry necessary would be to the amounts of the purchase-money and nonpurchase-money obligations and the amount of payments the debtor made.

case.<sup>217</sup> Section 9-103(h) invites the court to fashion a rule. It does not bar a court from using the section 9-103 application rules. A court can use a rule that it is not compelled to use. For example, courts use the promissory estoppel rule of section 90 of the Restatement (Second) of Contracts to enforce a promise regardless that the state legislature has not adopted the Restatement.<sup>218</sup>

Other courts fashion their own payment rules. A popular application method is “first-in, first-out,” illustrated in *In re Conn.*<sup>219</sup> The court in that case responded to the assertion that allocating payments between purchase-money and nonpurchase-money obligations was too complicated absent a contractual or legislative method: “We believe that one of the simplest and most direct methods of allocating payments to secured items is the first-in, first-out method.”<sup>220</sup> The court then applied payments to items in the order in which the items were purchased.<sup>221</sup> “Use of this method facilitates fairness and certainty of result . . . . It provides an easily applied rule of thumb . . . .”<sup>222</sup> The first-in, first-out rule is perhaps the most easily applied of all allocation rules.<sup>223</sup> The court need only determine the order in which the debtor incurred the various debts and the amount of payments made. Additionally, it might be closest to the unexpressed intent of the debtor. A debtor would logically expect that debts would be paid in the order of their incurrence. Also, this method has the advantage of a sense of fairness because the oldest debts are paid first.

Recently, some courts have adopted a pro rata payment rule for a dual status purchase-money security interest.<sup>224</sup> These courts determine the percentages that the

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<sup>217</sup> § 9-103 cmt. 8.

<sup>218</sup> See *School-Link Techs., Inc. v. Applied Res., Inc.*, 471 F. Supp. 2d 1101, 1114 (D. Kan. 2007); *Kiely v. St. Germain*, 670 P.2d 764, 767 (Colo. 1983); *Shampton v. City of Springboro*, 786 N.E.2d 883, 887 (Ohio 2003).

<sup>219</sup> *In re Conn.*, 16 B.R. 454, 458 (Bankr. W.D. Ky. 1982).

<sup>220</sup> *Id.*

<sup>221</sup> *Id.*

<sup>222</sup> *Id.* at 459.

<sup>223</sup> The first-in, first-out method of *In re Conn.* varies from the Article 9 adaptation of the first-in, first-out rule of U.C.C. § 9-103(e)(3) in that the type of debt is irrelevant under *Conn.* Subsection 9-103(e)(3) applies payments first to unsecured debts, then to purchase-money obligations.

<sup>224</sup> See, e.g., *In re Busby*, 393 B.R. 443, 451 (Bankr. S.D. Miss. 2008); *In re Riach*, 2008 WL 474384, at \*4 (Bankr. D. Or. 2008); *In re Munzberg*, 388 B.R. 529, 547-48 (Bankr. D. Vt. 2008); *In re Conyers*, 379

purchase-money and nonpurchase-money obligations bear to the total obligation at the time of the consolidation or future advance.<sup>225</sup> Any payments made are applied to the debt in proportion to those percentages.<sup>226</sup> For example, if the purchase-money obligation is \$1500 and the nonpurchase-money obligation is \$1000, the purchase-money part of the debt is 66.67%, and the nonpurchase-money part is 33.33%. Any payments the debtor makes are applied in accordance with those percentages. An alternate pro rata method used by some courts is to compute the percent that each obligation bears to the total obligation at the origin of the dual status security interest and to apply those percentages to the total debt at the time of bankruptcy.<sup>227</sup> For example, if the purchase-money obligation is \$1600 and the secured party makes a \$400 future advance, the applicable percentages are, respectively, 80% purchase-money and 20% nonpurchase-money. If the total debt at the filing of bankruptcy is \$1600, the purchase-money part is \$1280 and the nonpurchase-money part is \$320. Pro rata application has the attributes of ease of use and seemingly aligns with the intent of the parties.<sup>228</sup> A debtor whose total obligation is comprised of purchase-money and nonpurchase-money parts might expect that any payments would be split pro rata among the debts.

Accruals of interest or penalty charges on an obligation potentially cause a problem for allocating payments. Insofar as these charges arise from the purchase-money obligation, they should be part of the purchase-money obligation. Official Comment 3 to section 9-103 states that the definition of purchase-money obligation

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B.R. 576, 583 (Bankr. M.D. N.C. 2007); *In re Pajot*, 371 B.R. 139, 162 (Bankr. E.D. Va. 2007), *rev'd in part*, *GMAC v. Horne*, 390 B.R. 191, 203 (E.D. Va. 2008). These courts adopted a payment allocation method after holding that the security interest was dual status because “negative equity” was not part of a purchase-money obligation. *See infra* note 239 for a further explanation of “negative equity.”

<sup>225</sup> *See In re Riach*, 2008 WL 474384, at \*5 (Bankr. D. Or. 2008); *In re Conyers*, 379 B.R. 576, 583 (Bankr. M.D.N.C. 2007).

<sup>226</sup> *See In re Riach*, 2008 WL 474384, at \*5 (Bankr. D. Or. 2008); *In re Conyers*, 379 B.R. 576, 583 (Bankr. M.D.N.C. 2007).

<sup>227</sup> *See In re Brodowski*, 391 B.R. 393, 403 (Bankr. S.D. Tex. 2008); *In re Crawford*, 397 B.R. 461, 468 (Bankr. E.D. Wis. 2008).

<sup>228</sup> Potential problems with the “pro rata” allocation of payments on a consolidated debt have arisen as far back as 1965. *See Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965). The appeals court remanded the case to consider the unconscionability of a provision in an installment purchase agreement that allocated payments in a manner that a balance was retained on every item the debtor purchased until the debtor made the final payment. *Id.* at 450.

includes “finance charges,” “administrative charges,” and “other similar obligations.”<sup>229</sup> Conversely, if such charges arise from the nonpurchase-money obligation, they are not part of the purchase-money obligation. The parties create a potential problem if they consolidate the purchase-money and nonpurchase-money loans into a single obligation and interest and penalties accrue on that obligation. In that case, however, it is possible to allocate finance charges and penalties in the same ratio that purchase-money bears to nonpurchase-money because the court can assume that interest and penalties accumulate proportionally.<sup>230</sup> Several courts have done so.<sup>231</sup> The application formula of section 9-103(e) does not address the issue, perhaps indicating the drafters assumed that such charges would accumulate proportionally.<sup>232</sup>

Other payment options exist. Many jurisdictions have adopted retail installment sales statutes that provide for a method of applying payments.<sup>233</sup> If the purchase-money security interest was created in such a transaction, the court can

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<sup>229</sup> 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.

U.C.C. § 9-103 cmt. 3.

<sup>230</sup> *In re Pajot*, 371 B.R. 139, 161 (Bankr. E.D. Va. 2007); *In re Lavigne*, Nos. 07-30192, 07-31402, 07-31247, 06-32914, 2007 WL 3469454, at \*12 (Bankr. E.D. Va. Nov. 14, 2007). The court should be able to ascertain the ratio that each obligation bears to the total obligation at the time of refinancing or consolidation. That calculation must be made if purchase-money and nonpurchase-money obligations are consolidated regardless of whether interest and penalties accrue.

<sup>231</sup> See *In re Pajot*, 371 B.R. 139, 161 (Bankr. E.D. Va. 2007); *In re Lavigne*, Nos. 07-30192, 07-31402, 07-31247, 06-32914, 2007 WL 3469454, at \*12 (Bankr. E.D. Va. Nov. 14, 2007).

<sup>232</sup> The payments rule of the Uniform Consumer Credit Code applies payments first to finance charges in the order of entry to the account and then to the payment of the debts. U.C.C.C. § 3.303(2) (1974), 7 U.L.A. 189 (2002).

<sup>233</sup> See, e.g., GA. CODE ANN. § 10-1-8 (2011) (Georgia Retail Sales and Home Solicitation Act); 815 ILL. COMP. STAT. 405/22 (2011) (Illinois Retail Installment Sales Act); MICH. COMP. LAWS ANN. § 445.861 (West 2011) (Michigan Retail Installment Sales Act); VT. STAT. ANN. tit. 9, § 2405 (2011) (Vermont Retail Installment Sales Act); WASH. REV. CODE § 63.14.110 (2011) (Washington Installment Sales of Goods and Services Act).

apply the applicable allocation statute.<sup>234</sup> The Uniform Consumer Credit Code, enacted in eleven states, adopts a “first-in, first-out” application method for payment of cross-collateral security interests.<sup>235</sup> A cross-collateral security interest exists when a secured party secures a new obligation with new collateral and with collateral that secures a previous debt and also secures the previous debt with the new collateral. Although a refinancing or future advance does not necessarily create a cross-collateral transaction, a judge nevertheless could recognize the fairness to both parties of the U.C.C.C. allocation method and apply first-in, first-out to the case regardless of whether the jurisdiction has enacted the U.C.C.C. The Restatement (Second) of Contracts provides a payment rule that combines first-in, first-out with aspects of section 9-103(e)(3). Payments are applied first to the “earliest matured debt . . . , except that preference is given . . . (i) to overdue interest rather than principle, and (ii) to an unsecured . . . debt rather than one that is secured . . . .”<sup>236</sup> Courts frequently implement Restatement principles.<sup>237</sup>

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<sup>234</sup> *Pristas v. Landaus of Plymouth, Inc.*, 742 F.2d 797, 801-02 (3rd Cir. 1984); *In re Brouse*, 6 U.C.C. Rep. Serv. (CBC) 471 (Bankr. W.D. Mich. 1969).

<sup>235</sup> U.C.C.C. § 3.303 (1974), 7 U.L.A. 188 (2002). Five states (Colorado, Idaho, Iowa, Kansas, and Maine) have enacted the 1974 act. 7 U.L.A. 188 (2002). The 1968 Code, U.C.C.C. § 2.409 (1968), 7 U.L.A. 387 (2002), included the identical provision. Six states (Indiana, Oklahoma, South Carolina, Utah, Wisconsin, and Wyoming) have enacted the 1968 act without amendment. 7 U.L.A. 285 (2002).

<sup>236</sup> RESTATEMENT (SECOND) OF CONTRACTS § 260(2) (1981). The Restatement recognizes and embraces the concept that the parties can agree to a payment allocation. A performance should be applied first according to the obligor’s direction, RESTATEMENT (SECOND) OF CONTRACTS § 258 (1981), and, if no direction, then according to the creditor’s intention, RESTATEMENT (SECOND) OF CONTRACTS § 259 (1981). If neither direction nor intention is found, then a performance should be applied according to section 260(2). RESTATEMENT (SECOND) OF CONTRACTS § 260(2) (1981).

<sup>237</sup> *See, e.g.*, *School-Link Techs., Inc. v. Applied Res., Inc.*, 471 F. Supp. 2d 1101, 1114 (D. Kan. 2007); *Kiely v. St. Germain*, 670 P.2d 764, 767 (Colo. 1983); *Shampton v. City of Springboro*, 786 N.E.2d 883, 887 (Ohio 2003).

A court should not be reluctant to adopt a payment method when the parties' agreement or other law does not provide it.<sup>238</sup> Implementing a method is not "making a contract" for the parties. The contract exists. Action by the court furthers the parties' intention in having a purchase-money security interest. Furthermore, that action gives effect to the words "to the extent" of section 9-103(b)(1). Utilizing a payment method does not require the court to untangle a mass of transactions. Determining the amount of add-on debt incurred by a future advance, with or without refinancing, is not a difficult burden. There are many different ways the court can apply payments. When necessary, a court should act.

## VII. CURRENT CASES AND LEGISLATION

### A. Case Law

Currently, the issue of whether to apply dual status or transformation to a consumer goods purchase-money security interest frequently arises in cases that are determining whether "negative equity" in a motor vehicle financing security interest qualifies as a purchase-money obligation.<sup>239</sup> That question became relevant as a result of the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).<sup>240</sup> The act amended section 1325(a) of the Bankruptcy Code by adding what is commonly called the "hanging paragraph."<sup>241</sup>

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<sup>238</sup> See Russell A. Hakes, *According Purchase Money Status Proper Priority*, 72 OR. L. REV. 323, 396-97 (1993); see also Mary Aronov, *The Transformation Rule Applied to Purchase Money Security Interests in Commercial Lending Transactions*, 16 MEM. ST. U. L. REV. 15, 49 (1985); Bernard A. Burk, *Preserving the Purchase Money Status of Refinanced or Commingled Purchase Money Debt*, 35 STAN. L. REV. 1133, 1162-64 (1983); Ann E. Conaway Stilson, *The "Overloaded" PMSI in Bankruptcy: A Problem in Search of a Resolution*, 60 TEMP. L.Q. 1, 36 (1987). *But see* Dienna Ching, *Does Negative Equity Negate the Hanging Paragraph?*, 16 AM. BANKR. INST. L. REV. 463, 496-97 (2008).

<sup>239</sup> See, e.g., *In re White*, 417 B.R. 102 (Bankr. S.D. Ind. 2009). Negative equity is a situation frequently encountered in motor vehicle financing. The buyer wishes to trade an existing vehicle toward the purchase of a new vehicle. The value of the vehicle is less than the amount the debtor owes on it, i.e., negative equity. The seller of the new vehicle is willing to advance the purchase price of the new vehicle as well as funds to pay off the existing loan. The seller then takes a security interest in the new vehicle to secure the total obligation.

<sup>240</sup> Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23.

<sup>241</sup> The provision is called the "hanging paragraph" because it was added at the end of 11 U.S.C. § 1325(a) without a paragraph number.

The hanging paragraph applies to purchase-money security interests that satisfy timing and collateral requirements established in section 1325(a).<sup>242</sup> It precludes the debtor's "cram down" of a chapter 13 bankruptcy plan.<sup>243</sup> Consequently, the background for many dual status and transformation cases has shifted from Bankruptcy Code section 522(f) to section 1325(a), although section 522(f) continues to allow avoidance only if the security interest is in nonpurchase-money.<sup>244</sup>

Although the issue is arising in bankruptcy courts, those courts continue to apply the Article 9 definition of purchase-money security interest because the Bankruptcy Code does not define purchase-money security interest.<sup>245</sup> Courts use the Article 9 definition despite the statement in Official Comment 8 to section 9-103 that Article 9 "does not, and could not, determine a question of federal law" without authorization from federal law.<sup>246</sup> That comment was added to clarify that the drafters took "no position on the meaning of 'nonpurchase-money security interest' for purposes of lien avoidance under Bankruptcy Code § 522(f)."<sup>247</sup> Nevertheless, many bankruptcy courts begin their inquiry with the Article 9 definition of purchase-money security interest. *In re Peaslee* is illustrative.<sup>248</sup>

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<sup>242</sup> 11 U.S.C. § 1325(a)(9) (2010).

<sup>243</sup> "Cram down" refers to the right of a debtor to obtain confirmation of a Chapter 13 plan that pays the holder of a secured claim the amount of the allowed secured claim rather than the amount of the total claim. 11 U.S.C. § 1325(a)(5)(B)(ii) (2010).

<sup>244</sup> See Ching, *supra* note 238, at 496-97.

<sup>245</sup> See, e.g., *In re Westfall*, 599 F.3d 498, 502 (6th Cir. 2010); *In re Howard*, 597 F.3d 852, 855 (7th Cir. 2010); *In re Dale*, 582 F.3d 568, 573 (5th Cir. 2009); *In re Mierkowski*, 580 F.3d 740, 742 (8th Cir. 2009); *In re Ford*, 574 F.3d 1279, 1283 (10th Cir. 2009); *In re Price*, 562 F.3d 618, 624 (4th Cir. 2009); *In re Peaslee*, 547 F.3d 177, 184 n.13 (2d Cir. 2008). But see *In re Westfall*, 376 B.R. 210, 218-19 (Bankr. N.D. Ohio 2007), *rev'd*, *In re Westfall*, 599 F.3d 498, 502 (6th Cir. 2010); Juliet M. Moringiello, *A Tale of Two Codes: Examining § 522(f) of the Bankruptcy Code, § 9-103 of the Uniform Commercial Code and the Proper Role of State Law in Bankruptcy*, 79 WASH. U. L.Q. 863, 865-80 (2001).

<sup>246</sup> "[W]hether a security interest is a 'purchase-money security interest' under other law is determined by that law. For example, decisions under Bankruptcy Code Section 522(f) have applied both the dual-status and the transformation rules. The Bankruptcy Code does not expressly adopt the state law definition of 'purchase-money security interest.' Where federal law does not defer to this Article, this Article does not, and could not, determine a question of federal law." U.C.C. § 9-103 cmt. 8.

<sup>247</sup> PEB REPORT, *supra* note 26, at 99 n.6.

<sup>248</sup> *In re Peaslee*, 547 F.3d 177 (2d Cir. 2008).

Congress, presumably aware that its prior use of this term of art had led courts to resort to state law and that state law responded with Comment 8, once again used this term of art without providing a federal definition or any interpretive guidance. Thus, notwithstanding Comment 8, we believe Congress, in accordance with “the settled principle that creditors' entitlements in bankruptcy arise in the first instance from the underlying substantive law creating the debtor's obligation, subject to any qualifying or contrary provisions of the Bankruptcy Code,” meant to incorporate state law to define the term “purchase money security interest” in the BAPCPA.<sup>249</sup>

These courts are adopting dual status if they decide that negative equity is not part of a purchase-money obligation.<sup>250</sup> In negative equity cases, purchase-money and nonpurchase-money obligations are created in the same transaction when the lender advances funds to purchase the new collateral—purchase-money—and also advances funds to pay off the balance owed on the trade-in vehicle—nonpurchase-money and negative equity. The new vehicle is the collateral that secures both obligations. The issue is whether the purchase-money security interest is dual status or is transformed into a nonpurchase-money security interest because of the nonpurchase-money obligation. Courts adopting dual status are finding support for their decision from the Article 9 definition of purchase-money security interest in section 9-103, although mindful that the section 9-103 dual status rule does not apply to a consumer goods purchase-money security interest.<sup>251</sup> For example, in *In re Munzberg*, the bankruptcy judge noted that the “to the extent” language of section 9-103(b) allows collateral to secure a nonpurchase-money obligation without losing purchase-money status.<sup>252</sup> Similarly, the bankruptcy judge in *In re McCauley* stated

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<sup>249</sup> *Id.* at 185 n.13 (citation omitted).

<sup>250</sup> See, e.g., *In re Munzberg*, 388 B.R. 529, 546 (Bankr. D. Vt. 2008); *In re Busby*, 393 B.R. 443, 452 (Bankr. S.D. Miss. 2008); *In re Acaya*, 369 B.R. 564, 570 (Bankr. N.D. Cal. 2007).

<sup>251</sup> See, e.g., *In re Mancini*, 390 B.R. 796, 806-08 (Bankr. M.D. Pa. 2008); *In re Acaya*, 369 B.R. 564, 570-71 (Bankr. N.D. Cal. 2007); *In re Lavigne*, Nos. 07-30192, 07-31402, 07-31247, 06-32914, 2007 WL 3469454 (Bankr. E.D. Va. 2007), *rev'd on other grounds*, *GMAC v. Horne*, 390 B.R. 191 (E.D. Va. 2008) (holding negative equity is a purchase-money obligation); *In re McCauley*, 398 B.R. 41, 47 (Bankr. D. Colo. 2008), *declined to follow by*, *In re Ford* 574 F.3d 1279 (10th Cir. 2009) (holding the entire debt to be a purchase-money obligation).

<sup>252</sup> *Munzberg*, 388 B.R. at 546.

that “to the extent” in the UCC definition “seems to contemplate a ‘dual status’ rule.”<sup>253</sup>

The courts that adopt the transformation rule have done so on various grounds. The judge in *In re Huddle* relied on pre-Revised Article 9 precedent: “The Fourth Circuit decision . . . remains good law in the consumer-goods context and compels a determination that the purchase-money character of 1st Advantage's security interest was lost when the original loan was refinanced and a portion of the proceeds used to bring a separate loan current.”<sup>254</sup> Other courts justify adopting the transformation rule because of the difficulty of determining what part of the security interest is purchase-money and what part is nonpurchase-money.<sup>255</sup> In *In re Price*, the judge remarked that the task of computing what part is purchase-money, along with allocating the payments, would be “virtually impossible.”<sup>256</sup> The court in *In re Blakeslee* declined “the task of ‘unwind[ing] the manipulations’ which would be foisted upon it were it to apply the dual status rule to the financing of negative equity in retail installment contracts.”<sup>257</sup>

A few courts are willing to adopt the dual status rule only if the agreement of the parties provides a method for determining the purchase-money and nonpurchase-money parts. In *In re Tuck*, the court found that the security interest lost its purchase-money status because the contract failed to provide a method of allocating payments between the purchase-money part and the negative equity.<sup>258</sup>

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<sup>253</sup> *McCauley*, 398 B.R. at 47.

<sup>254</sup> *In re Huddle*, 2007 WL 2332390, at \*4 (Bankr. E.D. Va. 2007) (citing *Dominion Bank of Cumberland, NA v. Nuckolls*, 780 F.2d 408 (4th Cir. 1985)). The precedential value of *Nuckolls* can be questioned because the facts stated in the opinion show that the original purchase-money loan was unsecured. The security interest was created when the purchase-money loan was refinanced and at that time the goods purchased previously were used as collateral for the obligation. *Nuckolls*, 780 F.2d at 410.

<sup>255</sup> *In re Peaslee*, 358 B.R. 545 (Bankr. W.D.N.Y. 2006), *rev'd on other grounds*, *In re Peaslee*, 585 F.3d 53 (2d Cir. 2009) (holding negative equity is purchase-money).

<sup>256</sup> *In re Price*, 363 B.R. 734, 745-46 (Bankr. E.D.N.C. 2007) citing *Peaslee* 358 B.R. at 558-59, *rev'd*, *In re Wells Fargo Fin. N.C. 1, Inc.*, No. 5:07-CV-133-BR, 2007 WL 5297071 (Bankr. E.D.N.C. 2007). The district court judge adopted the dual status rule on the ground that it furthered better the intent of the hanging paragraph of Bankruptcy Code § 1325(a). The Fourth Circuit reversed the district court on the ground that negative equity is purchase-money. *In re Price*, 562 F.3d 618 (4th Cir. 2009).

<sup>257</sup> *In re Blakeslee*, 377 B.R. 724, 730 (Bankr. M.D. Fla. 2007).

<sup>258</sup> *In re Tuck*, No. 06-10886-DHW, 2007 WL 4365456 at \*4 (Bankr. M.D. Ala. 2007).

The judge in *In re Bray* rejected purchase-money status for the debt because “the loan documents do not provide a method for (1) apportioning the amount of the debt between the purchase money and nonpurchase money portions or (2) allocating the payments to the different portions of the loan.”<sup>259</sup>

### B. Legislation

Eleven states address the dual status and transformation issue with legislation. Nine states have followed the early drafts of Revised Article 9 and enacted a section 9-103 that applies the dual status, allocation and burden of proof rules to all purchase-money security interests. Florida, Idaho, Indiana, Kansas, Louisiana, Maryland, Nebraska, North Dakota, and South Dakota all delete the limiting words of uniform sections 9-103(e), (f), and (g) that make the rules of those sections inapplicable to purchase-money security interests in consumer goods.<sup>260</sup> Consequently, in those jurisdictions purchase-money status remains regardless of future loans or refinancing and regardless of whether the agreement of the parties provides for allocation of payments.<sup>261</sup>

Connecticut and Tennessee have modified their versions of section 9-103(e) to include a payment rule applicable to a consumer goods purchase-money security interest.

In a consumer-goods transaction, if the extent to which a security interest is a purchase-money security interest depends on the application of a payment to a particular obligation:

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<sup>259</sup> *In re Bray*, 365 B.R. 850, 862 (Bankr. W.D. Tenn. 2007).

<sup>260</sup> Florida, FLA. STAT. ANN. § 679.1031 (West 2011); Idaho, IDAHO CODE ANN. § 28-9-103 (2011); Indiana, IND. CODE ANN. § 26-1-9.1-103 (West 2011); Kansas, KAN. STAT. ANN. § 84-9-103 (2011); Louisiana, LA. REV. STAT. ANN. § 10:9-103 (2011); Maryland, MD. CODE ANN., COM. LAW § 9-103 (West 2011); Nebraska, NEB. REV. STAT. § 9-103 (2011); North Dakota, N.D. CENT. CODE § 41-09-03 (2011); and South Dakota, S.D. CODIFIED LAWS § 57A-9-103 (2011). All of these jurisdictions except Louisiana have also omitted section 9-103(h) from 9-103. Louisiana retained it as “[Reserved].” LA. REV. STAT. ANN. § 10:9-103 (2011).

<sup>261</sup> See *Citifinancial Auto v. Hernandez-Simpson*, 369 B.R. 36, 46 (D. Kan. 2007) *abrogated by In re Ford*, 574 F.3d 1279, 1286 (10th Cir. 2009) (holding negative equity is a purchase-money obligation); *In re Stevens*, 368 B.R. 5, 8 (Bankr. D. Neb. 2007); Christopher Harry, *To Be (Transformed), or Not To Be: The Transformation Versus Dual-Status Rules for Purchase-Money Security Interests Under Kansas’ Former and Revised Article 9*, 50 KAN. L. REV. 1095, 1122-24 (2002).

(A) The payment must be applied so that the secured party retains no purchase money security interest in any property as to which the secured party has recovered payments aggregating the amount of the sale price including any finance charges attributable thereto; and (B) For the purposes of this subsection only, in the case of items purchased on different dates, the first item purchased shall be deemed the first paid for and, in the case of items purchased on the same date, the lowest priced item shall be deemed first paid for.<sup>262</sup>

Yet, both states inexplicably retain the other limiting provisions of section 9-103.<sup>263</sup> As a result, the dual status rule of section 9-103(f) continues to apply only to purchase-money security interests other than consumer goods purchase-money security interests.<sup>264</sup> Consequently, courts of those jurisdictions must still decide whether to apply dual status or transformation. A reasonable implication from adopting the payment rule is that dual status is preferred. A Tennessee bankruptcy court judge, considering whether to apply dual status, declared “what relevance would allocation [the allocation provision of Tennessee’s section 9-103] have if a purchase money security interest was transformed when collateral also secures nonpurchase money debt?”<sup>265</sup>

It is doubtful that the UCC drafters will amend the consumer goods purchase-money security interest limitations of section 9-103. The limitations were the result of a compromise, making it unlikely that the issue will be revisited. Although amendments to Article 9 have been approved recently by ALI and NCCUSL, the amendments make no change to section 9-103.<sup>266</sup> Other states could amend section 9-103 to apply its dual status and payment rules to consumer goods

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<sup>262</sup> CONN. GEN. STAT. § 42a-9-103a(e)(2) (2011); *see also* TENN. CODE ANN. § 47-9-103(e)(2) (2011).

<sup>263</sup> CONN. GEN. STAT. § 42a-9-103a (2011); TENN. CODE ANN. § 47-9-103 (2011).

<sup>264</sup> CONN. GEN. STAT. § 42a-9-103a (2011); TENN. CODE ANN. § 47-9-103 (2011).

<sup>265</sup> *In re* Hayes, 376 B.R. 655, 674 (Bankr. M.D. Tenn. 2007) (citing *In re* Nolen, 53 B.R. 235, 237 (Bankr. M.D. Tenn. 1985)). *But cf.* *In re* Bray, 365 B.R. 850, 860 (Bankr. W.D. Tenn. 2007) (declining to adopt the dual status rule, notwithstanding the Tennessee statute, unless the parties’ agreement provides a method for determining the extent of the purchase-money and nonpurchase-money parts of the security interest and a method for applying payments).

<sup>266</sup> AMENDMENTS TO UNIFORM COMMERCIAL CODE ARTICLE 9 (NCCUSL, Jul. 9 - Jul. 16, 2010), *available at* [http://www.law.upenn.edu/bll/archives/ulc/ucc9/2010am\\_approved.htm](http://www.law.upenn.edu/bll/archives/ulc/ucc9/2010am_approved.htm) (last visited Feb. 7, 2011).

purchase-money security interests. However, the impetus for legislative change may be difficult to find.

### VIII. CONCLUSION

Whether a future advance or refinancing of a consumer goods purchase-money security interest terminates the purchase-money status of the security interest has been in doubt since the enactment of Article 9. The definitions of purchase-money security interest in previous official texts of Article 9 never expressly answered the question. The attempt of the drafters of Revised Article 9 to definitively resolve the issue was derailed by the “consumer compromise.” In most jurisdictions, the issue is now left to the courts.

Nevertheless, the definition of purchase-money security interest in Article 9 has always included the key to deciding the issue: “to the extent.” A security interest is purchase-money “to the extent” the goods secure the indebtedness that enables the debtor to purchase the goods. That phrase indicates that a security interest can be purchase-money to the extent the goods secure the enabling debt and nonpurchase-money to the extent they do not. It clearly contemplates a dual status rule. A future advance, refinancing, or consolidation should not transform the underlying nature of the purchase-money obligation unless the parties intend to terminate the purchase-money debt. Courts should give effect to the words of section 9-103 and apply the dual status rule.

Adopting the dual status rule does make the task of the court more difficult if the debtor makes a payment on an obligation that is part purchase-money and part nonpurchase-money. Unless the parties’ agreement indicates how to allocate the debt between the two parts, a court must decide on an appropriate application. That involves determining the amount of each part of the security interest and deciding if or how to divide the payment between the parts. It is an insurmountable barrier for some courts. Others take on the task.

Application of payments is neither impossible nor overwhelming. First-in, first-out—where the oldest debt is paid first—is perhaps the easiest for a court to apply. A court need only determine the oldest debt. Pro rata—where the payment is applied proportionately to the percentage each part bears to the whole—is not difficult to apply. A court need only determine the appropriate ratios. And not to be overlooked is the payment rule of section 9-103(e). A court seeking an application

method could apply the section on a case-by-case basis as needed to implement the dual status rule.

There are compelling reasons why dual status should be the appropriate rule for consumer goods purchase-money security interests. Dual status fits the Article 9 definition of purchase-money security interest. Additionally, there is no unanticipated adverse effect on the debtor or other creditors if the security interest is part purchase-money and part nonpurchase-money. Applying the rule does not place a heavy burden on the court. Finally, the parties intended for the secured party to have a purchase-money security interest, and a court should respect that intent.