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Raymond B. Check
University of Michigan Law School

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The Transformation Rule Under Section 522 of the Bankruptcy Code of 1978

INTRODUCTION

Much of the consumer debt in the United States arises from the purchase of household goods.¹ Commonly, a seller extending credit or a lender advancing money for these purchases retains a security interest in the goods until the debt is repaid.² This security interest gives the creditor the right to repossess the goods should the debtor default on the loan.³

Consumer debt is often refinanced to bring a delinquent account current or to consolidate a prior loan with a new advance.⁴ Typically, the debtor requests either a new advance of money or an extension of time for repayment of an existing note. In either event, the creditor issues a new note whose balance includes the previous obligation.⁵

The security interest taken by a seller or lender in ordinary household goods is called a "purchase money security interest,"⁶ and is accorded special treatment in several circumstances by the Uniform

1. The amount of consumer credit extended for the purchase of general consumer durable goods is second only to the amount advanced for the purchase of automobiles, mobile homes, boats, aircraft and recreational vehicles. CONSUMER CREDIT IN THE UNITED STATES: REPORT OF THE NATIONAL COMMISSION ON CONSUMER FINANCE 123 (1972) [hereinafter cited as NCCF REPORT]. About 40% of consumers purchasing durable goods do so on credit. T. DURKIN & G. ELLIEHAUSEN, 1977 CONSUMER CREDIT SURVEY 73 (1978) [Federal-Reserve-sponsored study, hereinafter cited as FEDERAL RESERVE STUDY]. See generally R. COLE, CONSUMER AND COMMERCIAL CREDIT MANAGEMENT 42, 101 (7th ed. 1984).

2. The Uniform Commercial Code [hereinafter cited as U.C.C.] defines a security interest as "an interest in personal property . . . which secures payment or performance of an obligation." U.C.C. § 1-201(38) (1985). The Bankruptcy Code definition is almost identical. See 11 U.S.C. §§ 101(28), 101(37) (1982) ("lien" means a charge against or interest in property to secure payment of a debt; "security interest" means a lien created by agreement).

3. U.C.C. § 9-503 provides that a secured party "has on default the right to take possession of the collateral." One survey indicates that "creditors [think] the single most important remedy or contract provision in a secured consumer credit transaction [is] the right to take a security interest in the goods (use the goods as collateral for the transaction) and the concomitant right to repossess if the debtor default[s]." NCCF REPORT, *supra* note 1, at 29-30.

4. Refinancing is defined as the "discharge of an obligation with funds acquired through the creation of a new debt." BLACK'S LAW DICTIONARY 1152 (5th ed. 1979). One court has described the possible variations of refinancing:

[T]he process involves an existing note that is "paid by renewal" or "flipped." The "new" or renewed note incorporates the balance still owing on the old note. Sometimes the renewal note merely extends the time of payment for the amount due on the old note. Other times a number of old notes are "consolidated" into one "new" note. Another practice is to renew an old note and give an additional cash advance in the renewal note, sometimes taking an additional security interest in new or different collateral.

In re Gibson, 16 Bankr. 257, 262 (Bankr. D. Kan. 1981).

5. In one court's words, "[t]he outstanding balance on the first note is, on paper at least, paid off with funds from the second note." *In re Conn*, 16 Bankr. 454, 459 (Bankr. W.D. Ky. 1982).

6. U.C.C. § 9-107 (1985) defines a "purchase money security interest" as follows:

Commercial Code (U.C.C.).⁷ When a debt secured by a purchase money security interest is refinanced, however, the traditional view taken by the bankruptcy courts has been that the lender's purchase money interest is transformed, becoming nonpurchase money in character.⁸ This view is known as the "transformation rule."⁹

The purchase money/nonpurchase money distinction gained new significance in 1978 when Congress enacted a comprehensive reform of the Bankruptcy Code.¹⁰ In a major break with prior law, section 522 of the new Code sets forth exemption-and-avoidance provisions¹¹

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.

7. Official comment 1 to U.C.C. § 9-107 lists some instances in which purchase money obligations take priority over other obligations. For present purposes, the most important attribute of purchase money status under the U.C.C. is that public filing of a financing statement is unnecessary to perfect a purchase money interest in consumer goods. U.C.C. § 9-302(1)(d) (1985). An unperfected or tardily perfected security interest is not enforceable in bankruptcy. See note 18 *infra* and accompanying text.

Recently, scholars have questioned the favorable treatment afforded the claims of secured creditors under both bankruptcy law and the U.C.C. Compare White, *Efficiency Justifications for Personal Property Security*, 37 VAND. L. REV. 473 (1984) (security is economically efficient) with Schwartz, *The Continuing Puzzle of Secured Debt*, 37 VAND. L. REV. 1051 (1984) (favored treatment of secured debt is without justification).

8. See, e.g., *In re Matthews*, 724 F.2d 798, 800 n.3 (9th Cir. 1984) (holding that "issuance of a new loan extinguishes the purchase money character of the security interest"); *In re Manuel*, 507 F.2d 990 (5th Cir. 1975); *In re Rosen*, 17 Bankr. 436 (Bankr. D.S.C. 1982); *In re Jones*, 5 Bankr. 655 (Bankr. M.D.N.C. 1980). The cases are collected in Note, *Section 522(f): A Proposal for the Survival of Purchase Money Security Interests Following Refinancing*, 18 TULSA L.J. 280 n.2 (1982). See also Butler, *Lien Avoidance Under Section 522(f) in the District of South Carolina*, 35 S.C. L. REV. 311, 323-30 (1984).

9. See *In re Gayhart*, 33 Bankr. 699, 700 (Bankr. N.D. Ill. 1983); *In re Russell*, 29 Bankr. 270, 272 (Bankr. W.D. Okla. 1983).

The term "transformation rule" is also used to describe the view that purchase money status in collateral is lost entirely if the collateral acts as security for any debt other than its purchase price, as it does under retail credit arrangements providing that earlier-purchased items are not freed from the security agreement when paid for, but remain as collateral for later-purchased items.

This Note is limited to the question of whether a purchase money security interest is automatically transformed into a nonpurchase money security interest upon refinancing. It assumes that purchase money status is not lost if the collateral acts as security for more than its purchase price. If the alternative view were adopted, most refinancings would be subject to transformation whether or not the refinancing was held to automatically transform purchase money status, because after refinancing the collateral secures additional interest charges, a new cash advance, or other consolidated debts. See generally McLaughlin, *"Add-On" Clauses in Equipment Purchase Money Financing: Too Much of a Good Thing*, 49 FORDHAM L. REV. 661 (1981).

In adopting the version of the rule described in this Note, the Ninth Circuit failed to reach the issue of collateral securing more than its own price, but implied that it does not favor that formulation of the rule. *In re Matthews*, 724 F.2d 798, 800 n.3 (9th Cir. 1984) ("The weight of authority appears to be against the debtors on this point.").

10. The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified in scattered sections of 11 & 28 U.S.C.).

11. The provisions are found in 11 U.S.C. § 522 (1982). One bankruptcy judge has written: The [1978] Code's grant to the debtor of avoiding powers on exempt property rivals the uniform [federal] exemption scheme of § 522(d) in importance. . . . The avoiding powers

that enable a debtor undergoing bankruptcy to retain certain types of exempt property subject to otherwise valid nonpossessory,¹² nonpurchase money security interests.¹³ Because only *nonpurchase money* security interests may be avoided, whether a refinanced purchase money security interest is "transformed" into a nonpurchase money security interest determines whether the debtor is allowed to keep the secured property.

Most bankruptcy courts faced with refinanced purchase money security interests under section 522 of the new Bankruptcy Code¹⁴ have

set out in the Code . . . go far beyond whatever powers the bankrupt had under the old law in concept and even farther in application.

Hughes, *Code Exemptions: Far Reaching Achievement*, 28 DE PAUL L. REV. 1025, 1036-37 (1979).

12. A possessory security interest is one in which the creditor takes physical possession of the collateral. The pawnshop is the classic example of such an arrangement. See J. WHITE & R. SUMMERS, *HANDBOOK OF THE LAW UNDER THE UNIFORM COMMERCIAL CODE* § 23-10, at 933-34 (2d ed. 1980) [hereinafter cited as WHITE & SUMMERS].

13. Section 522(b) allows the debtor to exempt property from his estate in bankruptcy, and allows debtors to choose between federal and state exempt-property lists unless the state opts out of this arrangement. Section 522(d) sets out the federal exemptions. Section 522(f) provides:

Notwithstanding any waiver of exemptions, the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is —

1) a judicial lien; or

2) a *nonpossessory, nonpurchase-money security interest* in any —

A) household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, or jewelry that are held primarily for the personal, family, or household use of the debtor or a dependant of the debtor;

B) implements, professional books, or tools, of the trade of the debtor or the trade of a dependant of the debtor; or

C) professionally prescribed health aids for the debtor or a dependant of the debtor.

11 U.S.C. § 522(f) (1982) (emphasis added).

In states that have "opted out" of the federal exemption scheme under § 522(b), debtors may still use § 522(f) to avoid liens on property exempt under state law. See Comment, *Protection of a Debtor's "Fresh Start" Under the New Bankruptcy Code*, 29 CATH. U. L. REV. 843, 860 n.142 (1980). The following states have enacted legislation displacing the federal exemptions: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Missouri, Montana, Nebraska, Nevada, New Hampshire, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming. 3 W. COLLIER, *BANKRUPTCY* § 522.02 n.4a (15th ed. 1985).

The 1978 Act was amended in 1984 in response to the sudden increase in bankruptcy filings that followed the 1978 Act. See note 137 *infra*. The general effect of the 1984 amendments was to make it more difficult for individuals to qualify for relief, and to extend the rights of creditors, including unsecured creditors. The change most directly relevant to this discussion is the imposition of a \$4000 aggregate limit on the household property that may be exempted under § 522. See Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 306(b), 98 Stat. 333, 353 (amending 11 U.S.C. § 522(d)(3)). The 1984 changes are surveyed in Chatz & Schumm, *1984 Bankruptcy Code Amendments — Fresh from the Anvil*, 89 COM. L.J. 317 (1984); Snider, Rochkind, Green, Stein & Welford, *The Bankruptcy Amendments and Federal Judgeship Act of 1984*, 63 MICH. B.J. 775 (1984).

14. Bankruptcy courts must apply state law in determining whether or not a purchase money security interest retains its purchase money character after refinancing. Once the status of the security interest is determined, federal law dictates whether or not the interest will be enforceable in bankruptcy. See *Lewis v. Manufacturers Natl. Bank*, 364 U.S. 603 (1961) (state law determines status of creditor's claims; bankruptcy court then applies federal bankruptcy law to determine which claims may be avoided). See also H.R. REP. NO. 595, 95th Cong., 1st Sess. 5,

applied the transformation rule¹⁵ and thus have allowed debtors to avoid the liens on their exempt property. Recently, however, several bankruptcy courts have rejected the transformation rule as formalistic and contrary to the policies of the Bankruptcy Code.¹⁶ These courts have held that refinancing does not automatically extinguish the purchase money character of a security interest and so render it avoidable under section 522.

This Note rejects the statutory arguments that have been advanced in favor of the transformation rule, and argues that the rule is inconsistent with both the policies motivating section 522 of the Bankruptcy Code and the overall purposes of the U.C.C. priority system. Part I examines the treatment of purchase money security in the U.C.C. scheme. It also describes the exemption provisions of the 1978 Bankruptcy Code and the legislative concerns that shaped those provisions. Part II summarizes the judicial adoption of the transformation rule and the statutory basis relied upon by courts in applying it. Part III argues that neither the statutory language nor the policies underlying the U.C.C. and the Bankruptcy Code justify the transformation rule. Part III concludes further that application of the rule will have unfavorable consequences for consumer financing transactions. The Note therefore suggests that courts would better serve the interests of both debtors and creditors by holding that purchase money security interests in household goods retain their purchase money character following refinancing.

I. STATUTORY TREATMENT OF PURCHASE MONEY SECURITY INTERESTS

A. *The U.C.C.*

Under the U.C.C., either a seller or a lender may acquire a purchase money security interest upon a sale of goods on credit.¹⁷

reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5963, 5966 [hereinafter cited as HOUSE REPORT]; *In re Conn*, 16 Bankr. 454, 456 (Bankr. W.D. Ky. 1982) ("Although the debtors . . . argue that . . . lien avoidance is governed solely by bankruptcy law, the precondition of lien avoidance, nonpurchase money status, derives from state statute.").

All states but Louisiana have adopted the U.C.C. § 9-107 definition of "purchase money security interest," see note 6 *supra*, as their "local" law. 3 U.L.A. 1-2 (Master ed. 1981).

15. "The vast majority of courts that have considered the issue . . . have held that refinancing or consolidating loans . . . extinguishes the purchase money character of the original loan" *In re Matthews*, 724 F.2d 798, 800 (9th Cir. 1984).

16. See, e.g., *In re Moore*, 33 Bankr. 72 (Bankr. D. Or. 1983); *In re Russell*, 29 Bankr. 270 (Bankr. W.D. Okla. 1983); *In re Conn*, 16 Bankr. 454 (Bankr. W.D. Ky. 1982); *In re Gibson*, 16 Bankr. 257 (Bankr. D. Kan. 1981).

17. Section 9-107 provides that a seller's security interest in collateral is purchase money "to the extent that it is . . . taken or retained . . . to secure all or part of [the collateral's] price." U.C.C. § 9-107(a) (1985). A lender acquires a purchase money security interest "to the extent that . . . by making advances or incurring an obligation [she] gives value to enable the debtor to acquire rights in or use of [the] collateral." U.C.C. § 9-107(b) (1985).

This purchase money security interest, if perfected,¹⁸ gives priority¹⁹ to the claims of a store that sells merchandise on credit, taking the item sold as collateral for its price, and to the claims of a bank that extends a loan secured by the item to be purchased with the loan money.²⁰

Unlike most security interests, which are perfected only if the creditor files a financing statement,²¹ purchase money security interests in consumer goods are automatically perfected.²² Before passage of the Bankruptcy Reform Act of 1978, automatic perfection was the most significant difference between purchase money and nonpurchase money security interests.²³ Typically, the issue arose in a "priority battle" between creditors to decide which of them had the better claim

18. The U.C.C. defines perfection only by designating what steps must be taken to achieve it (§ 9-303), but official comment 1 to U.C.C. § 9-301 (1985) explains that "the term 'perfected' is used to describe a security interest in personal property which cannot be defeated in insolvency proceedings or in general by creditors."

While a perfected security interest is enforceable in bankruptcy as a lien on the specific property identified as collateral, *see* note 19 *infra*, an unsecured creditor or a creditor holding an unperfected security interest will receive only a pro rata share of the bankrupt's estate after its liquidation. *See generally* WHITE & SUMMERS, *supra* note 12, § 23-5, at 918 ("[A] secured party who perfects prior to bankruptcy is likely to have the right to snatch the collateral out of the trustee's hands, but an unperfected secured party will invariably have to eat from the general creditors' trough in bankruptcy."). In practice, unsecured creditors rarely receive anything upon liquidation. COMPTROLLER GENERAL, U.S. GEN. ACCT. OFF., BANKRUPTCY REFORM ACT OF 1978 — A BEFORE AND AFTER LOOK 55 (1983) (Report to the Chairman of the House Judiciary Committee).

19. *See* U.C.C. § 9-312(4) (1985), which states that "[a] purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral . . . if the purchase money security interest is perfected . . ." In bankruptcy, a creditor with priority may ordinarily satisfy his entire claim out of the debtor's collateral "before the subordinate party satisfies himself to any extent." WHITE & SUMMERS, *supra* note 12, § 25-1, at 1031 (emphasis in original).

20. *See* note 17 *supra*.

21. U.C.C. § 9-302 (1985) states that "[a] financing statement must be filed to perfect all security interests" except in certain listed situations. This requirement establishes the "general rule" that perfection of security interests is accomplished by public filing. Official comment 1 to U.C.C. § 9-302 (1985); *see generally* WHITE & SUMMERS, *supra* note 12, § 23-5, at 918 ("By far the most common and important method [of perfection] is the filing of a financing statement.").

A financing statement "contains only enough information to notify a reader that the creditor named may claim an interest in described collateral of the debtor named. . . . [N]ormally it is merely a publicly filed notice that tells a reader where to hunt for more information." *Id.*

22. U.C.C. § 9-302(1)(d) (1985) excepts from the general financing statement filing requirement "a purchase money security interest in consumer goods." The U.C.C. follows prior practice in this regard. Automatic perfection spares lenders and the filing system the burden of filing interests in goods that other lenders are accustomed not to rely on for security and that, once used, would be of only marginal value if taken as collateral. *See* WHITE & SUMMERS, *supra* note 12, § 23-7, at 920.

Three states — Kansas, Maine, and Oklahoma — do not permit automatic perfection of purchase money security interests in consumer goods. Three other states have imposed purchase price limitations above which automatic perfection is not allowed: Maryland (\$500), Colorado (\$250), and Wisconsin (\$250). *Id.* at 925 n.119.

23. *See, e.g.,* W.S. Badcock Corp. v. Banks (*In re Norrell*), 426 F. Supp. 435 (M.D. Ga. 1977) (creditor with nonpurchase money security interest loses secured claim because of failure to file a financing statement).

to the collateral. If a refinanced loan lost its purchase money status because of the transformation rule, and the creditor did not perfect her security interest by filing a financing statement, the creditor's interest would no longer take priority over the security interests held by other creditors.²⁴

B. *The Bankruptcy Reform Act of 1978*

The Bankruptcy Reform Act added new significance to the purchase money/nonpurchase money distinction by allowing debtors to avoid nonpurchase money liens on certain household goods.²⁵ This feature of the Bankruptcy Code, embodied in the exemption-and-avoidance provisions of section 522, is largely attributable to two congressional concerns: (1) securing a meaningful fresh start for the debtor, and (2) limiting the impact of abusive credit practices.

1. *The Debtor's Fresh Start*

While the avowed purpose of bankruptcy discharge has always been to give the debtor/bankrupt²⁶ a "fresh start,"²⁷ Congress felt that achievement of this goal required stronger measures than previous law had provided.²⁸ It reasoned that if a debtor's basic household property was reclaimed upon bankruptcy by secured creditors, the debtor would have to go back into debt immediately after discharge to obtain items necessary for ordinary day-to-day living.²⁹ Thus, debtors would be denied the opportunity to begin again on a sound, debt free basis.

Federal bankruptcy law has always permitted debtors to exempt certain specified property from being sold to satisfy general creditors'

24. See, e.g., *Associates Fin. v. Conn*, 16 Bankr. 454, 456 (Bankr. W.D. Ky. 1982) (stating that "[the] consequence [in pre-Bankruptcy Code cases holding that refinancing transforms purchase money status] was the subordination of the creditor's security interest, unperfected for lack of proper filing, to the interest of the bankruptcy trustee").

25. "Section 522(f) of the Bankruptcy Code has shifted the importance of purchase money status from perfection to lien avoidance" by allowing avoidance of only nonpurchase money interests. *Associates Fin. v. Conn*, 16 Bankr. 454, 456 (Bankr. W.D. Ky. 1982).

26. Prior legislation had referred to an individual undergoing liquidation ("straight bankruptcy") as a "bankrupt," and to one undergoing rehabilitation as a "debtor." The 1978 Act uses the term "debtor" to refer to both, in part to reduce the stigma associated with the use of the label "bankrupt." HOUSE REPORT, *supra* note 14, at 310, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6267.

27. The development of the fresh start doctrine is traced in Comment, *supra* note 13, at 846-50.

28. "The two most important aspects of the fresh start available under the Bankruptcy laws are the provision of adequate property for a return to normal life, and the discharge, with the release from creditor collection attempts. Current law is deficient in both of these areas." HOUSE REPORT, *supra* note 14, at 125, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6086.

29. See, e.g., *Bankruptcy Act Revision: Hearings on H.R. 31 and H.R. 32 Before the Subcomm. on Civil and Constitutional Rights of the House Comm. on the Judiciary*, 94th Cong., 1st & 2d Sess. 939-40 (statement of Ernest L. Sarason, Jr., Staff Attorney, the National Consumer Law Center, Inc.) [hereinafter cited as *House Hearings*].

claims.³⁰ Prior to the 1978 Code, however, even exempt property was not protected from repossession by anyone holding a secured claim or lien against it.³¹ Congress altered this situation somewhat in the 1978 Code by allowing debtors to avoid nonpurchase money security interests in certain items, such as household goods and tools of employment, that it deemed especially important to debtors.³²

Some groups and individuals urged that debtors be allowed to avoid *all* security interests in exempt property, or alternatively that judges be left with discretion to allow avoidance of purchase money interests in individual cases.³³ Rather than make such a radical change, however, Congress fashioned an exemption-and-redemption scheme that both protected what it considered legitimate purchase money interests and strengthened the debtor's fresh start by allowing avoidance of nonpossessory, nonpurchase money security interests in the exempt property.³⁴

2. *Abusive Creditor Practices*

In strengthening the debtor's fresh start, Congress was especially concerned with limiting the effect of overreaching security arrangements in which the debtor assigns as security for a loan the used furniture and household goods he or she already owns and needs for daily life. Since used appliances, furniture, and other household goods have little monetary value and depreciate rapidly, this type of collateral provides little financial security to the lender even when first given as collateral.³⁵ Such goods are relatively expensive to replace, however, and are difficult to do without, so that the threat of repossession is a singularly effective method of coercing payment from a distressed debtor.³⁶ By drawing the purchase money/nonpurchase money dis-

30. See Note, *Bankruptcy Exemptions: A Full Circle Back to the Act of 1800?*, 53 CORNELL L. REV. 663, 666-67 (1968); Comment, *supra* note 13, at 847.

31. See 2 H. REMINGTON, A TREATISE ON THE BANKRUPTCY LAW OF THE UNITED STATES § 910 (1956) (creditor with secured claim on exempt property is entitled to payment in full); Hughes, *supra* note 11, at 1036.

32. See notes 11-13 *supra* and accompanying text. See also Vukowich, *Debtors' Exemption Rights Under the Bankruptcy Reform Act*, 58 N.C. L. REV. 769 (1980).

Another new feature of the 1978 Code was the provision of a uniform federal exempt-property list. Previously, state law had provided the descriptions and dollar limitations on property eligible for exemption. See generally Hughes, *supra* note 11. Under § 522(b), however, states may replace the federal list with their own exempt-property statutes. To date, 36 states have chosen this option. See note 13 *supra*. See also Hertz, *Bankruptcy Code Exemptions: Notes on the Effect of State Law*, 54 AM. BANKR. L.J. 339 (1980); Comment, *Exemptions Under the Bankruptcy Code: Using California's New Homestead Law as a Medium for Analysis*, 72 CALIF. L. REV. 922 (1984) (examining exemptions in California, a state that has opted out of the federal exemption scheme).

33. See, e.g., *House Hearings*, *supra* note 29, at 939-40; note 38 *infra*.

34. See note 13 *supra* and accompanying text.

35. See, e.g., WHITE & SUMMERS, *supra* note 12, § 23-7, at 923 (discussing the effect of rapid depreciation of most consumer goods on their value as collateral).

36. See *House Hearings*, *supra* note 29, at 761-62 (statement of David H. Williams, Attorney,

tion in section 522, Congress sought to prevent the use of these tactics by creditors while preserving the protection available to lenders who finance the acquisition of exempt property.³⁷

In deciding that purchase money liens would not be avoidable under section 522, Congress was acknowledging that there is a qualitative difference between lenders who take security interests in used goods merely for the psychological leverage that the threat of repossession provides, and those who *retain* security interests in goods that they have previously enabled the debtor to purchase.³⁸ Admittedly, because household goods depreciate rapidly, a purchase money lender will soon be in the same position as a lender who takes a security interest in used goods: the security interest will cease to have much monetary value, and will come to function mostly as a psychologically coercive device to force repayment.³⁹ In recognition of this problem, however, Congress enacted a specific safeguard to ensure that non-avoidable purchase money liens would be limited to their proper scope. Section 722 of the new Code gives the debtor an unwaivable right to redeem exempt consumer property by paying the lienholder the fair market value of the collateral or the amount of the allowed claim, whichever is less.⁴⁰ Thus, if the collateral secured by a

FTC Bureau of Consumer Protection) (FTC study shows that virtually all consumer creditors took blanket security interests in household necessities, and that the security was used chiefly for psychological leverage rather than as grounds for repossession). *See also* Comment, *supra* note 13, at 848-49 (footnotes omitted):

[A] common technique of creditors was to take security interests in a necessary item, such as the debtor's automobile, and then threaten to deprive the debtor of its use by repossession if the debtor failed to reaffirm his debt after bankruptcy. By taking such necessary collateral, creditors used security interests to obtain bargaining power far in excess of the liquidation value of that collateral.

37. *See* HOUSE REPORT, *supra* note 14, at 127, *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 5963, 6088.

38. In testimony before the House, Ernest L. Sarason, Jr., staff attorney for the National Consumer Law Center, Inc., voiced approval of the nonpurchase money avoidance power and urged that Congress expand the avoidance power to include purchase money interests. He noted that the National Commission on Consumer Finance had recommended that creditors not be allowed to take nonpurchase money security interests in household goods, and that the Uniform Commercial Credit Code and a proposed FTC regulation prohibited most nonpurchase money security interests in consumer goods. He went on to say that the Model Consumer Credit Act prohibits even purchase money security interests in personal effects, household furnishings, appliances, and clothing. *House Hearings, supra* note 29, at 953.

In response to Mr. Sarason's proposal that § 522(f) exemptions be expanded to allow avoidance of purchase money interests, Rep. Butler commented, "I find it difficult to see how we can wipe out the interest of the [purchase money] creditor just arbitrarily because the man has chosen to file bankruptcy." *Id.* at 953. *See also* note 115 *infra*. The Model Consumer Credit Act, which *would* "wipe out" purchase money security interests in certain goods, has yet to be entirely adopted by any state.

39. Of course, the goods depreciate just as rapidly for the purchase money secured party as they do for the nonpurchase money lender. A notable difference, however, is that the purchase money creditor at least starts off with collateral equal in value to the amount of the debt.

40. The statute states:

An individual debtor may, whether or not the debtor has waived the right to redeem under this section, redeem tangible personal property intended primarily for personal, family, or

purchase money lien has depreciated by the time of bankruptcy to the point where repossession is of little financial value to the creditor, it will be relatively easy for the debtor to redeem the collateral rather than allow it to be repossessed.⁴¹

II. THE JUDICIAL GENESIS OF THE TRANSFORMATION RULE

Courts have derived the transformation rule⁴² from the definition of "purchase money security interest" provided in U.C.C. section 9-107.⁴³ Section 9-107(b) states that a security interest is purchase money to the extent that it is "taken by a person who . . . gives value to enable the debtor to acquire rights in or the use of collateral. . . ." ⁴⁴ The security interest obtained through refinancing does not meet this definition, it is argued, because the debtor has *already* obtained rights in the collateral by virtue of a prior credit sale.⁴⁵ This argument thus focuses on the fact that there has been a "new" loan. The fact that a previous loan by the same creditor had originally enabled the debtor to acquire rights in the collateral is deemed irrelevant to the character of the second loan.

The transformation rule finds additional support in the last sentence of the second official comment to section 9-107. The comment explains that the language of section 9-107(b) is meant to exclude from purchase money status "any security interest taken as security for or in satisfaction of a pre-existing claim or antecedent debt."⁴⁶ Courts have reasoned that a refinancing is by definition the payment of an

household use, from a lien securing a dischargeable consumer debt, if such property is exempted under § 522 of this title . . . by paying the holder of such lien the amount of the allowed secured claim of such holder that is secured by such lien.

11 U.S.C. § 722 (1982). Courts have construed § 722 liberally in favor of debtors. *See, e.g., Associates Fin. v. Fitzgerald*, 20 Bankr. 27 (Bankr. N.D.N.Y. 1982). *See generally* Butler, *Section 722: A Redeeming Aspect of the Bankruptcy Code*, 88 COM. L.J. 462 (1983).

41. *See, e.g., In re Hobby*, 18 Bankr. 70, 75 (Bankr. W.D. Ky. 1982) (Redemption allows the debtor "to retain his necessary property and avoid the high replacement cost that might be required if the secured creditor repossessed."); *see also House Hearings, supra* note 29, at 953 (dialogue between Mr. Parker and Mr. Sarason). Note, however, that if the debtor cannot afford to redeem his property, the secured creditor is still entitled to repossess it, even if the debtor has paid off most, but not all, of the debt.

42. That is, the rule that a purchase money security interest loses its purchase money status when the obligation underlying it is refinanced. *See* notes 8-9 *supra* and accompanying text.

43. *See* note 6 *supra*.

44. U.C.C. § 9-107(b) (1985).

45. *See, e.g., In re Matthews*, 724 F.2d 798, 800 (9th Cir. 1984) ("[The debtors] did not use the [refinancing] proceeds to acquire rights in or the use of the piano or stereo. They already owned them.").

46. Comment 2 reads in full:

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

Official comment 2 to U.C.C. § 9-107 (1985).

antecedent debt and the substitution of a new obligation, different in some way from the first.⁴⁷ Therefore, the "new" security interest created by the refinancing cannot be classified as a purchase money interest.

The crucial assumption underlying the transformation rule is that a refinancing should be viewed as an entirely new agreement that erases the obligations consolidated into it and creates a new debt and new security interest unrelated in character to the refinanced debts. If the refinancing is thus characterized as "paying off the old loan and extending a new one,"⁴⁸ then it follows that purchase money status is lost, because the refinancing terminates the prior purchase money interest and substitutes a new security interest in the *same* collateral.⁴⁹ The new security interest is nonpurchase money in character because it secures, not the purchase money for the collateral, but the repayment of an antecedent debt.⁵⁰

The recent Ninth Circuit case *In re Matthews*⁵¹ is the first decision by a circuit court adopting the transformation rule as described above.⁵² A detailed consideration of *Matthews* is valuable because its factual situation is typical of those cases in which transformation questions arise,⁵³ and because the court makes a superficially persuasive argument for the proposition that refinancing automatically terminates purchase money status.

In *Matthews*, Transamerica Corporation advanced money to enable the debtors to buy a stereo and a piano, and it took a security interest in those goods.⁵⁴ Approximately a year later, Transamerica refinanced the original loan. The refinancing agreement paid insurance charges, reduced the dollar amount of the debtor's monthly payments, and provided the debtors with a small amount of cash.⁵⁵

47. In adopting the transformation rule, courts have reasoned from the official comments as well as from the actual language of § 9-107. See, e.g., *Rosen v. Associates Fin. Servs.*, 17 Bankr. 436, 437 (D.S.C. 1982); *In re Hobdy*, 18 Bankr. 70, 72-73 (Bankr. W.D. Ky. 1982); *In re Ward*, 14 Bankr. 549, 552 (S.D. Ga. 1981); *In re Jones*, 5 Bankr. 655, 657 (Bankr. M.D.N.C. 1980).

48. *In re Matthews*, 724 F.2d 798, 800 (9th Cir. 1984).

49. See text at notes 44-45 *supra*.

50. See, e.g., *In re Jones*, 5 Bankr. 655, 657 (Bankr. M.D.N.C. 1980) ("The purpose of the renewal note was to pay off the original note, an antecedent debt. The purchase money character of the security interest was extinguished when the proceeds from the first renewal note were used to satisfy the original note.").

51. 724 F.2d 798 (9th Cir. 1984).

52. *Matthews* notes that the transformation rule, as articulated in *In re Jones*, 5 Bankr. 655 (Bankr. M.D.N.C. 1980), see note 50 *supra*, has been adopted by the "vast majority" of bankruptcy courts, as well as by the two federal district courts that have considered the issue. 724 F.2d at 800-01.

53. *In re Gibson*, 16 Bankr. 257, 259-61 (Bankr. D. Kan. 1981), an opinion deciding six consolidated cases, also provides illustrations of the context in which transformation issues are raised.

54. 724 F.2d at 799. The loan was paid directly to the merchants who sold the items.

55. 724 F.2d at 799.

About a year after the refinancing, the debtors filed for bankruptcy. In deciding that Transamerica held only an avoidable nonpurchase money security interest in the stereo and piano, the court held the lender strictly to the form of the refinancing agreement.⁵⁶ The court went on to emphasize that Transamerica itself had made the decision to issue a "new loan," and that Transamerica had described the refinancing *not* as an extension of payments on the old loan, but as payment of "net balance due."⁵⁷

III. CRITICISM OF THE TRANSFORMATION RULE

Several bankruptcy courts have declined to follow the reasoning that led the *Matthews* court to adopt the transformation rule, and have instead held that refinancing a debt leaves a purchase money security interest unchanged.⁵⁸ These courts have argued that a refinancing is "merely a renewal of a previous obligation"⁵⁹ and consequently does not alter the purchase money status and nonavoidable nature of the creditor's security interest.⁶⁰ This renewal is distinguished from the creation of an entirely new agreement (referred to as a novation).⁶¹ Whether a refinancing is a renewal or a novation depends largely on the extent to which the obligations of the debtor have been changed.⁶²

56. The court stated:

The argument that form should not be elevated over substance has merit in some settings, but not here. We are dealing with a statutory scheme that governs the priorities among creditors. Purchase money security is an exceptional category in the statutory scheme that affords priority to its holder over other creditors, but only if the security is given for the precise purpose as defined in the statute. And we should not lose sight of the fact that the lender chooses the form.

724 F.2d at 801.

57. 724 F.2d at 800 (emphasis added).

58. See, e.g., *In re Gayhart*, 33 Bankr. 699 (Bankr. N.D. Ill. 1983); *In re Russell*, 29 Bankr. 270 (Bankr. W.D. Okla. 1983); *In re Stevens*, 24 Bankr. 536 (Bankr. D. Colo. 1982); *In re Chambell*, 17 Bankr. 597 (Bankr. W.D. Mo. 1982); *In re Conn*, 16 Bankr. 454 (Bankr. W.D. Ky. 1982); *In re Gibson*, 16 Bankr. 257 (Bankr. D. Kan. 1981).

59. *In re Gayhart*, 33 Bankr. 699, 699 (Bankr. N.D. Ill. 1983).

60. See, e.g., *In re Gayhart*, 33 Bankr. at 700:

Though in its 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, and increased in amount by, another obligation. The refinancing changes the character of neither the balance due under the first loan nor the security interest taken under it.

quoting *In re Russell*, 29 Bankr. 270, 273 (Bankr. W.D. Okla. 1983).

61. A "novation" is the "[s]ubstitution of a new contract, debt or obligation for an existing one, between the same or different parties." BLACK'S LAW DICTIONARY 959 (5th ed. 1979).

62. See, e.g., *In re Gayhart*, 33 Bankr. 699, 700 (Bankr. N.D. Ill. 1983) ("In delineating between a novation and a renewal, the courts have focused on the degree to which the original obligation of the debtor has changed and, to some extent, on any additional consideration which was conveyed by the debtor to the creditor."). The intent of the parties may also be relevant under state law. *In re Matthews*, 724 F.2d 798 (9th Cir. 1984), for example, noted that under California law a novation does not occur without the express intent of the parties. *Matthews* found that intent, holding that the refinancing documents "unequivocally expressed [Transamerica's] intent to make a new loan 'to pay net balance due.'" 724 F.2d at 801.

Thus, where refinancing has resulted only in reduced monthly payments by the debtor, at a higher interest rate, courts have held that the refinancing is a renewal and that the creditor maintains its purchase money security interest.⁶³ To hold otherwise, courts have argued, would elevate the form of a refinancing transaction over its substance.⁶⁴

A. U.C.C. Construction: *Intents and Purposes*

Because the Bankruptcy Code adopts state law determinations as to whether a security interest is purchase money or nonpurchase money,⁶⁵ and state law is in almost every instance the U.C.C.,⁶⁶ courts on both sides of the issue look first to the U.C.C. in deciding whether to apply the transformation rule. At least one court has felt bound by the language of U.C.C. section 9-107 to adopt the rule regardless of its effects. In allowing avoidance of the lender's security interest, the court in *Rosen v. Associates Financial Services Company*⁶⁷ stated:

While such a result may be inequitable, particularly in a situation like the present one in which the original purchase money loan was refinanced at the debtor's request and for his convenience, this court feels that no other result is possible under the explicit language of [the U.C.C. and the Bankruptcy Code].⁶⁸

However, the language of section 9-107 is not so unequivocal as to compel the transformation rule.⁶⁹ If a court considers refinancing a transaction in which "what is owed on the original note is not eliminated, [but] is merely transferred to, and increased in amount by, another obligation,"⁷⁰ then the original debt may survive and retain its purchase money character under section 9-107.

63. See *In re Gayhart*, 33 Bankr. 699, 701 (Bankr. N.D. Ill. 1983) ("A new note given in lieu of an existing note between the same parties and for the same indebtedness, even at a higher rate of interest and due at a later date, is not given for a new consideration, and, therefore, does not constitute a novation.") (quoting *First Natl. Bank & Trust Co. v. Daniel*, 701 F.2d 141, 142 (11th Cir. 1983)).

64. See, e.g., *In re Russell*, 29 Bankr. 270, 273 (Bankr. W.D. Okla. 1983) ("To follow debtors' contention [that the security interest was transformed into nonpurchase money] would be to ignore the substance of the refinancing transaction.").

65. See note 14 *supra*.

66. *Id.*

67. 17 Bankr. 436 (D.S.C. 1982).

68. 17 Bankr. at 438. In *Rosen*, the debtor purchased appliances with a \$2500 loan from a finance company; both parties agreed that this gave the company a valid purchase money security interest in the appliances. Shortly thereafter, the company extended a loan for approximately \$3000, secured by the same appliances. The second loan incorporated the balance due under the first and also paid the insurance premiums due under several insurance policies. Soon afterwards the debtor filed for bankruptcy and claimed the appliances as exempt.

69. One court, in fact, has explicitly noted that "nowhere in the Uniform Commercial Code is it said [that] a purchase money interest is transformable." *In re Gibson*, 16 Bankr. 257, 267 (Bankr. D. Kan. 1981).

70. *In re Conn*, 16 Bankr. 454, 459 (Bankr. W.D. Ky. 1982).

In the absence of clear statutory language favoring a given interpretation, a court should go behind the words of the statute and examine the underlying purposes sought to be achieved by its drafters.⁷¹ Indeed, this principle is explicitly mentioned by the drafters of the U.C.C. in the comments to the section containing its rules of construction. Comment 1 to that section first cautions that "the proper construction of the Act requires that its interpretation and application be limited to its reason,"⁷² and it then goes on to suggest that even clear statutory commands should be ignored if the result they dictate is not consistent with the rationale of the statute.⁷³ The *Matthews* court itself acknowledged this need to refer to purpose in interpreting the U.C.C.⁷⁴

The distinction drawn in section 9-107 between purchase and non-purchase money security was intended largely as a means for determining priorities among creditors claiming the same collateral.⁷⁵ The use of the purchase money distinction in the exemption-and-avoidance provisions of the 1978 Bankruptcy Code adds new considerations by shifting the focus from priorities among creditors to the determination of rights to collateral between a consumer debtor and a lender.⁷⁶ Since the considerations that shaped the provisions of section 9-107 itself are

71. See F. McCaffrey, *STATUTORY CONSTRUCTION* 1 (1953).

72. Official comment 1 to U.C.C. § 1-102 (1985). The U.C.C.'s first rule of construction commands that the Code be "liberally construed and applied to promote its underlying purposes and policies." U.C.C. § 1-102(1) (1985). One court rejecting the transformation rule as excessively formalistic has noted that "there is no indication in the Comment [to § 9-107] that § 9-107 is not to be construed liberally." *In re Russell*, 29 Bankr. 270, 273 (Bankr. W.D. Ok. 1983).

73. The comment applauds courts that "have disregarded a statutory limitation of remedy where the reason of the limitation did not apply." "Nothing in this Act," the drafters conclude, "stands in the way of the continuance of such action by the courts." Official comment 1 to U.C.C. § 1-102 (1985).

White & Summers argue that interpreting Code language in light of its rationale is "[n]ot only . . . more likely to produce results that the drafters intended; it probably also makes for more predictability and uniformity in the long run." WHITE & SUMMERS, *supra* note 12, § 4, at 18. Uniformity is itself a goal of the U.C.C. See note 93 *infra* and accompanying text.

74. The Court recognized the need to elevate substance over form "in some settings," but concluded that it was inappropriate to do so in the context of purchase money security interests: "We are dealing with a statutory scheme that governs the priorities among creditors. Purchase money security is an exceptional category in the statutory scheme that affords priority to its holder over other creditors, but only if the security is given for the precise purpose as defined in the statute." *In re Matthews*, 724 F.2d 798, 801 (9th Cir. 1984).

The court's concern with the priorities between creditors appropriately reflects the importance of the transformation rule as regards nonexempt property. See note 24 *supra* and accompanying text. However, this concern is not relevant to a § 522 situation, since the only possible results when *exempt* household goods are at issue are that the debtor will retain the collateral free from all liens, or the purchase money creditor will repossess it. In no event will it become available for satisfaction of other creditors' claims if it has been properly claimed as exempt.

75. See notes 17-24 *supra*; see generally Gilmore, *The Purchase Money Priority*, 76 HARV. L. REV. 1333 (1963) (extensive discussion of the pre-Code case law that shaped the Code's purchase money provisions). It was this purpose of governing priorities among creditors that the *Matthews* court stressed. See note 74 *supra*.

76. See notes 10-13 *supra* and accompanying text.

not the same as those arising in its use under section 522 of the new Bankruptcy Code,⁷⁷ the proper construction of section 9-107 in this context should be determined by reference to the broader purposes of the U.C.C.

1. *Simplicity, Clarity, Modernity*

The first-listed purpose of the U.C.C. is "to simplify, clarify and modernize the law governing commercial transactions."⁷⁸ As a canon of construction, this goal calls upon courts to favor interpretations of the U.C.C. that are commercially simpler and more efficient.⁷⁹ As between creditors and debtors, it is difficult to see how the transformation rule furthers the goal of simplifying the affairs of either. The effect of the rule is to require lenders seeking purchase money protection to make all subsequent advances in separate instruments, each of which creates distinct obligations that lenders and debtors must keep track of.⁸⁰ By complicating lending transactions, the transformation rule imposes on lenders a burden that is required only by a rigid reading of a statute that was meant to be applied flexibly. This burden frustrates the U.C.C.'s goals of simplicity and clarity. More importantly, it does not appear to be justified in the long run by correspon-

77. That is, the U.C.C. drafters were concerned with whether a lender should be able to seize secured property to the prejudice of other creditors who had lent money to the debtor. Under § 522 of the Bankruptcy Code, the question is whether an individual's need to retain certain property in order to gain a "fresh start" should take precedence over the claims of various classes of lenders, including those who made purchase of the property possible. See note 38 *supra* and accompanying text.

78. U.C.C. § 1-102(2)(a) (1985).

79. Specifically regarding article 9, the official comment to § 9-101 says, "The aim of this Article is to provide a simple and unified structure within which the immense variety of present-day secured financing transactions can go forward with less cost and with greater certainty." Official comment to U.C.C. § 9-101 (1985).

An example of this goal in practice is the U.C.C.'s provision for automatic perfection of purchase money security interests in consumer goods. Automatic perfection spares lenders and the filing system the burden of filing notice of one of the most common types of security arrangements. See note 22 *supra*; see also G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY ¶ 19.4 (1965).

80. For instance, a lender who wishes to extend payments on an existing note, enable the debtor to purchase another item, and extend new cash to the debtor, will not be able to consolidate these three actions into one instrument and remain protected. Rather, at least two separate instruments will be required.

White & Summers address the analogous problem that arises under the allocation version of the transformation rule when several credit sales are consolidated and the court must decide the extent to which each item secures its own price. They suggest that one solution is "to consolidate only nickel and dime debt and to isolate big ticket items on separate and distinct accounts." They then caution that this solution "may be economically impractical." WHITE & SUMMERS, *supra* note 12, § 23-7, at 922. Even if this approach were practicable, under the *Matthews* transformation rule it would protect only consolidation refinancings, not time extensions. See note 124 *infra* and accompanying text. Professor White's preferred solution — providing contractual apportionment of payments — also will not save refinancings under the *Matthews* version of the rule.

ding benefits to debtors.⁸¹

2. Custom and the Understanding of the Parties

The second-listed purpose of the U.C.C. is "to permit the continued expansion of commercial practices through custom, usage and agreement of the parties."⁸² Courts ignore this purpose when they refuse to look beyond the refinancing contract to determine the true nature of the transaction.⁸³ Courts that apply a technical construction to refinancing agreements also ignore U.C.C. section 1-205(3), which provides that trade practices "give particular meaning to and supplement or qualify terms of an agreement."⁸⁴ According to comment 4 of section 1-205, the important element in a usage of trade is what the language "may fairly be expected to mean to the parties involved in the particular commercial transaction"⁸⁵ Thus, this section mandates that courts look beyond the letter of a refinancing agreement and inquire into the *expectations* of the parties to that agreement.

It is implausible to assume that most consumer debtors ponder whether a refinancing will change their lender's interest in their television from purchase money to nonpurchase money. Instead, it seems reasonable that the natural expectation of a debtor who refinances or consolidates a loan is that if the same collateral is on both the old and new forms, nothing has changed.⁸⁶

81. In fact, the transformation rule may have a substantial negative impact on debtors as well as creditors. See notes 130-40 *infra* and accompanying text.

82. U.C.C. § 1-102(2)(b) (1985).

83. There is ample support in the comments to article 9 for looking beyond the form of the transaction. For instance, the comment to § 9-101 explains that "[u]nder the Article distinctions based on form . . . are no longer controlling." Instead, "[t]he scheme of the Article is to make distinctions . . . along functional rather than formal lines." Official comment to U.C.C. § 9-101 (1985). On the question of whether a given transaction creates a security interest, official comment 1 to U.C.C. § 9-102 (1985) states, "When it is found that a security interest . . . was intended, this Article applies regardless of the form of the transaction or the name by which the parties may have christened it." In light of this language, it seems incongruous to make purchase money status depend on such factors as whether a note is marked "paid" or "paid by renewal."

84. U.C.C. § 1-205(3) (1985).

85. Official comment 4 to U.C.C. § 1-205(3) (1985).

86. When a consumer debtor obtains a finance company loan for a new washer and signs a security agreement, she probably understands that if she fails to repay the finance company, it may come and repossess the washer. (Note that this natural expectation of the seller's or lender's right to repossess is not present in the nonpurchase money "contract of adhesion, signed in ignorance" that Congress wished to allow the debtor to avoid. See HOUSE REPORT, *supra* note 14, at 127, reprinted in 1978 U.S. CODE CONG. & AD. NEWS 5963, 6088.)

If several weeks later the debtor decides that she needs a new dryer as well, she will probably go to the same finance company for the new loan. Through various paper adjustments not of particular interest to the debtor, the finance company will consolidate her prior loan so that she may pay for both appliances on one account. Unless the debtor in question is a bankruptcy lawyer who practices in the Ninth Circuit, she will almost certainly expect that her debt on the washer remains secured in the same manner as before. As far as the debtor is concerned, the consolidation has not changed the nature of the prior transaction; it has merely combined two otherwise distinct transactions into one agreement.

In the case of a time extension rather than a consolidation, it is even more obvious that, from

The creditor's reasonable understanding of the refinancing is also important to its interpretation.⁸⁷ Certainly, the creditor can be expected to be more sophisticated about security interests than the average debtor. But to the creditor, "the paying of the old note by execution of a renewal note is generally just a bookkeeping procedure."⁸⁸ To the extent that lenders expect to lose purchase money status on refinancing,⁸⁹ it is because the transformation rule has created that expectation. But the U.C.C.'s unifying theme is its subordination of legal form to the normal (and not the judicially created) commercial expectations of the parties to a transaction.⁹⁰ Justifying a formalistic rule by reference to the fact that some lenders have managed to conform their behavior to it is not consonant with this theme.

In those cases in which the parties actually *do* intend to extinguish their prior obligation and substitute a new one, courts properly can find that the refinancing constitutes a novation.⁹¹ The search for that intent should begin, however, with the substance of the transaction and the parties' understanding of it. Under the transformation rule, the search for intent begins and ends on the face of the refinancing agreement. Such an approach is contrary to proper U.C.C. interpretation.⁹²

3. Uniformity

The third-listed purpose of the U.C.C. is "to make uniform the law among the various jurisdictions."⁹³ But true uniformity is impossible when a statute is interpreted differently in bankruptcy and nonbankruptcy contexts, causing the same refinancing to be treated as a new obligation for some purposes and as a renewal for others.⁹⁴ The *Mat-*

the debtor's standpoint, what is being sought is not a new note or obligation, but an alteration in the terms of an existing one.

87. The *Matthews* court placed great emphasis on the lender's control over the form of the transaction. *In re Matthews*, 724 F.2d 798, 801 (9th Cir. 1984); text at note 57 *supra*.

88. *In re Gibson*, 16 Bankr. 257, 262 (Bankr. D. Kan. 1981).

89. The *Matthews* court, for instance, implies that loss of purchase money status was a result Transamerica chose in return for bringing the debtors' account current on its books. 724 F.2d at 800.

90. The primary spur to the creation of the U.C.C. was the need to modernize the law to conform to changing commercial practices. See Shattuck, *The Uniform Commercial Code — A Modernization of Commercial Law*, 35 WASH. L. REV. 398, 398-99 (1960). Article 9 in particular was designed to allow normal commercial activities to proceed without the danger of pitfalls created by technical statutes. *Id.* at 408. See also Schnader, *The Case for the Uniform Commercial Code*, 77 BANKING L.J. 633, 636 (1960) (prospectus prepared to solicit funds for initial drafting of the U.C.C. cited main need for it as the fact that contemporary commercial law was not "current with today's business practices").

91. See, e.g., *In re Averhoff*, 18 Bankr. 198 (Bankr. N.D. Iowa 1982); notes 61-62 *supra*.

92. See notes 82-85 *supra* and accompanying text.

93. U.C.C. § 1-102(2)(c) (1985).

94. One court, in rejecting the transformation rule, has observed that "[a]bsent specific congressional legislation to the contrary, the rules applicable to priorities in commercial law must be consistent whether in the context of bankruptcy or everyday commercial transactions." *In re*

thews approach creates a different rule for refinancings than that prevailing outside the bankruptcy courts.⁹⁵ Even within the bankruptcy arena, its treatment of refinanced obligations is inconsistent with the approach taken in cases not involving section 522 exemptions.⁹⁶

In nonbankruptcy contexts, the question of whether a refinancing is a new contract or a continuation of the previous one often arises when a lender refinances a note without filing a new financing statement. If the refinancing constitutes a new advance to pay off the old debt, it requires a separate filing for perfection.⁹⁷ If, however, the refinancing is merely a renewal of a prior obligation, no new filing is required.⁹⁸ In these nonbankruptcy cases courts have followed the overwhelming precode presumption that "notes given for notes previously held [do] not extinguish the original liability."⁹⁹ The determinative factor is the intent of the parties,¹⁰⁰ and courts assume that a refinancing is meant to be the continuation of a prior obligation rather than the creation of a new one.¹⁰¹ By following this practice consistently, courts ensure that like transactions will be treated alike under the statute. More importantly, by looking to the substance of the transaction, the rule ensures that the same refinancing practices will not be subject to inconsistent characterizations merely because different jurisdictions require different words or procedures.

Gibson, 16 Bankr. 257, 267 (Bankr. D. Kan. 1981). The court went on to note that it could not find a single nonbankruptcy case in which purchase money status had been transformed.

95. See notes 97-101 *infra* and accompanying text.

96. See notes 105-08 *infra* and accompanying text.

97. Filing is required because the debtor's prior obligation has been extinguished. The creditor must therefore take a new security interest under the new obligation. The general rule is that filing is required to perfect that new security interest. See note 21 *supra*.

98. If the refinancing is considered a renewal, the debtor's original obligation remains intact. Since this obligation is already secured, and the security interest is already perfected, no additional filing is necessary.

99. *Mid-Eastern Electronics, Inc. v. First Natl. Bank of S. Md.*, 455 F.2d 141, 144 (4th Cir. 1970). The court there held that even the return of the prior notes to the debtor is not conclusive on the nature of the refinancing transaction where both parties "understood, at the time the new notes were issued, that they were to be merely renewals or extensions of the underlying obligation." 455 F.2d at 145. See also *Index Store Fixture Co. v. Farmers' Trust Co.*, 19 U.C.C. Rep. Serv. (Callaghan) 284, 291 (Mo. Ct. App. 1976) (refinancing and consolidation "did not in any realistic way change the character of the balance due" under the earlier obligation; therefore, refinancing did not fall under nonpurchase money limitation in state usury law). *Accord* *Cantrill Constr. Co. v. Carter*, 418 F.2d 705, 706-07 (6th Cir. 1969); *Thorp Fin. Corp. v. Ken Hodgins & Sons*, 73 Mich. App. 428, 251 N.W.2d 614 (1977); *Bank of Austin v. Barnett*, 549 S.W.2d 428, 430 (Tex. Civ. App. 1977).

100. See, e.g., *Spector United Employees Credit Union v. Smith*, 263 S.E.2d 319, 321 (N.C. Ct. App. 1980); *Bank of Austin v. Barnett*, 549 S.W.2d 428, 430 (Tex. Civ. App. 1977).

101. The general approach was aptly described by one bankruptcy court that held a refinancing not to be a future advance: "Courts will . . . look behind the evidence of the debt and consider the debt itself, and decide according to that. . . . As long as the original debt can be traced the security remains, no matter how many renewals there have been." *In re McQueen*, 27 Bankr. 717, 722 (Bankr. D. Vt. 1983) (quoting *Robinson v. Leach*, 67 Vt. 128, 129, 31 A. 32, 33 (1895)) (emphasis omitted).

Uniformity is promoted rather than lost when courts reject formalistic readings of the U.C.C. and attend instead to the substance of the transactions before them and the impact of their decisions on similar, future transactions. For instance, courts have apparently never held that the assignment of a purchase money note from a seller to a finance company¹⁰² voids the note's purchase money character.¹⁰³ But such a holding would seem to be required by the literal language of the U.C.C.; the subsequent holder of the note falls into neither category of section 9-107.¹⁰⁴ Allowance of purchase money status after assignment can only be explained by reference to the substance of the transaction, which remains essentially purchase money in character. It is also likely that courts are unwilling to impose gratuitous burdens on credit sellers in the name of formal compliance with the U.C.C. By their attention to the goals of the U.C.C. and the commercial realities of the cases before them, courts have attained uniformity of result even without the explicit support of specific statutory language.

Even within the bankruptcy area, the *Matthews* approach is inconsistent with that taken by many courts in deciding whether refinancing agreements are properly characterized as entirely new obligations. For instance, several courts have upheld the validity of refinancing agreements against arguments that the refinancings constituted future advances¹⁰⁵ or preferences.¹⁰⁶ Others have similarly held that loans for the purchase of exempt property made before the effective date of the 1978 Code but refinanced after could not be avoided because the security interests related back in time to the original loan and retained their original purchase money character.¹⁰⁷ One of these courts summarized the state of the law as follows: "Synthesizing these cases, it

102. This type of arrangement is often called "factoring," which is defined as the "[s]ale of accounts receivable of a firm to a factor at a discounted price." BLACK'S LAW DICTIONARY 532 (5th ed. 1979). Factoring enables relatively small merchants to make credit sales and still maintain cash flow at viable levels. "[W]hen a purchaser on credit signs an installment note to the seller . . . , the note is usually 'negotiated' to a sales finance company or bank." U.S. DEPT. OF COMMERCE, CONSUMER CREDIT: FACTORS INFLUENCING ITS AVAILABILITY AND COST 11 (1976).

103. See Gilmore, *supra* note 75, at 1373; *In re Hobdy*, 18 Bankr. 70, 73 (Bankr. W.D. Ky. 1982) ("There is little, if any, case law which provides insight into this matter. In the several cases involving similar matters, the continued status of a purchase money security interest after assignment is assumed.").

104. The factor is not a seller and therefore cannot fall under § 9-107(a); nor has the factoring arrangement given value to enable the debtor to acquire rights in the collateral, as § 9-107(b) demands. The first comment to § 9-107, however, assumes without explanation the continuation of pre-U.C.C. practice by providing that "a financing agency has a purchase money security interest when it advances money to the seller, taking back an assignment of chattel paper." Official comment 1 to U.C.C. § 9-107 (1985).

105. See note 99 *supra* and accompanying text; *Blue v. H-K Corp.*, 629 P.2d 790 (Okla. Ct. App. 1981) (holding that a refinancing was not a future advance and that the security interest remained unchanged).

106. See, e.g., *First Natl. Bank of Clinton v. Julian*, 383 F.2d 329, 334 (8th Cir. 1967) (holding that a refinancing is a renewal, and not a preference, if the debtor's estate is undiminished).

107. See, e.g., *First Natl. Bank & Trust Co. v. Daniel*, 701 F.2d 141 (11th Cir. 1983); *In re*

becomes clear, excepting the effect of [section] 522(f), that when notes are renewed or consolidated or renewed coupled with the granting of additional credit, cash advances or collateral, the original note and security interest are not extinguished, unless the parties manifest such an intention."¹⁰⁸

One of the principal goals of the U.C.C. is to create uniformity from state to state.¹⁰⁹ When Congress used U.C.C. terminology in the Bankruptcy Code it meant to extend this uniformity so that similar transactions would be treated alike whether the question at hand arose in bankruptcy proceedings or in nonbankruptcy litigation.¹¹⁰ By establishing a formal rule based on an anomalous reading of the U.C.C., the *Matthews* court has destroyed this uniformity.

B. *The Transformation Rule and the Policies of the Bankruptcy Act*

In addition to being inconsistent with the purposes of the U.C.C., the transformation rule ignores the judgments that Congress embodied in the 1978 Bankruptcy Code. Specifically, the effect of the rule is to erode the distinction between purchase money and nonpurchase money interests, a distinction that Congress sought to preserve. The rule also threatens to curtail purchase money lending and refinancing, a result that Congress explicitly sought to avoid.

1. *Preservation of the Purchase Money/Nonpurchase Money Distinction under the Bankruptcy Code*

Congress designed the exemption and avoidance provisions of the Bankruptcy Code to strike a balance between debtors' need for protection from abusive creditor tactics and creditors' need for security in legitimate household-goods purchase transactions. The purpose of the avoidance provisions of the Act is to permit debtors to retain used household goods that the creditor did not help the debtor to acquire. Congress intended by these provisions to prevent creditors from obtaining undue influence over debtors by threatening to repossess necessary items.¹¹¹ The purpose of limiting the avoidance option to nonpurchase money interests was to protect those lenders whose credit had enabled the debtor to acquire the collateral in the first place.¹¹² Thus, the purchase money/nonpurchase money distinction in section 522 is the key to the legislative balance between debtors' and creditors' rights in exempt property.

Gibson, 16 Bankr. 257, 262 (Bankr. D. Kan. 1981); see also *Blue v. H-K Corp.*, 629 P.2d 790 (Okla. Ct. App. 1981).

108. *In re Gibson*, 16 Bankr. 257, 263 (Bankr. D. Kan. 1981).

109. See text at note 93 *supra*.

110. See note 94 *supra* and accompanying text.

111. See note 36 *supra* and accompanying text.

112. See notes 37-38 *supra* and accompanying text.

The usual effect of the transformation rule, however, is to ignore this distinction by treating refinanced purchase money debts and ordinary loans secured by presumptively abusive security agreements in the same way merely because of the manner in which the purchase money lender has chosen to proceed. For example, if a lender extends purchase money in one transaction and later makes a cash advance to the debtor in an entirely separate transaction, the indisputably correct result is that the first security interest will not be avoidable, but the one taken in the second transaction will. Similarly, in one instrument a lender may extend two sums of money, one to be used to purchase a television set and the other to pay a utility bill. The security interest in the television will be unavoidable to the extent that its price has not been repaid.¹¹³ Yet under the transformation rule, if the lender extends money to enable the purchase of the television, then later extends money to pay the utility bill under a contract consolidating the television debt, the debtor *will* be able to avoid the security interest in the television. The result, then, is that avoidance depends entirely on the timing and form of the agreements.

Congress, however, intended to make avoidance depend on the nonpurchase money character of the creditor's security interest,¹¹⁴ not on its form or timing. In so doing, it was giving a special status in bankruptcy to lenders or sellers whose credit had enabled the debtor to obtain exempt household goods.¹¹⁵ By extinguishing purchase money status, the transformation rule ignores the critical distinction drawn by Congress between lenders who have enabled debtors to acquire goods and those who have lent money and taken used goods as collateral.

Absent some compelling policy disfavoring refinancing, purchase money lenders should be permitted to retain the protections of purchase money status to the extent that the original purchase price of the secured goods remains unpaid. Not only is there no policy justification for disfavoring refinancing, there are compelling reasons to *favor* purchase money lending in general and refinancing in

113. This is only true, however, if the instrument itself limits the security interest to the price of the collateral, or if courts reject the argument that purchase money status is lost if the collateral acts as security for more than its purchase price. See note 9 *supra*. Rejection of that argument would seem to be mandated by U.C.C. § 9-107 (1985), which states that a security interest is purchase money "to the extent that" it secures its own price. However, some courts have held otherwise. See *In re Manuel*, 507 F.2d 990, 993 (5th Cir. 1975) (purchase money character of security interest is lost if security interest secures more than the price of the collateral).

114. See note 38 *supra* and accompanying text.

115. One court has found it "clear that Congress did not intend a debtor to avoid a lien which he granted in order to purchase the property in the first instance." *In re Moore*, 33 Bankr. 72, 74 (Bankr. D. Ore. 1983). See also *In re Russell*, 29 Bankr. 270, 274 (Bankr. W.D. Okla. 1983) ("Congress enacted 522(f) not for the purpose of permitting the consumer debtor to avoid security interest [sic] in collateral which was purchased by the money advanced but rather its purpose was to permit avoidance of security interests in already owned, household goods.").

particular.¹¹⁶

2. *The Effect of the Transformation Rule on Consumer Transaction Financing*

The transformation rule threatens to affect financing transactions in two ways. First, the rule may force some lenders to restrict credit and thereby hamper consumer access to exempt goods.¹¹⁷ Consumer transactions are promoted when creditors are able to take and maintain purchase money security interests in the goods purchased. As one court has observed, "purchase money security interests are not given preferred status to benefit only the creditor. Rather, '[t]he purchase money priority rule encourages the acquisition of new assets by the debtor.'"¹¹⁸ Transformation of purchase money status therefore threatens to restrict the amount of credit available. To the extent that lenders rely on the extra protection of purchase money status in extending loans, they will be reluctant to make loans — at least on comparable terms — to those consumers likely to request refinancing.¹¹⁹

More often mentioned is the prospect that the transformation rule will discourage refinancing. This is the second effect the rule will have on financing transactions: lenders who do make purchase money loans will be reluctant to refinance them, preferring instead to resort to the very remedies that the Bankruptcy Act sought to avoid.¹²⁰ The *Matthews* court asserted that "[l]enders will not be discouraged from

116. On the desirability of purchase money financing, see, e.g., *Pristas v. Landaus of Plymouth, Inc.*, 742 F.2d 797, 801 (3d Cir. 1984) (U.C.C. "gives favored treatment to [purchase money] financing arrangements on the theory they are beneficial both to buyers and sellers"). On the importance of refinancing to keep debtors out of bankruptcy, see note 140 *infra*.

117. It has been suggested that any decrease in creditors' rights may result in a restriction of credit to compensate for the increased risk. See NCCF REPORT, *supra* note 1, at 114: "In the face of limitations on remedies a creditor can either (1) increase rates to cover added collection costs [sic] and bad debt losses or (2) maintain the same rates but exercise more selectivity in granting credit. . . . Both will result in reduced availability." See also note 137 *infra*.

118. *In re Gibson*, 16 Bankr. 257, 265 (Bankr. D. Kan. 1981) (quoting *McLaughlin*, *supra* note 9). The implication is that lenders will make purchase money credit available for purchases for which they would not extend loans absent the additional protection of purchase money status.

119. Refinancing occurs in a large percentage of consumer credit arrangements. See *House Hearings*, *supra* note 29, at 761.

120. Of course, it is not necessarily bad to discourage creditors from refinancing the debts of already over-extended consumers, especially if those consumers want the refinancing to include new loans for further acquisitions. However, refinancing existing debt without allowing new acquisitions is an option which is often superior to a demand for payment on schedule, which may result in bankruptcy. Note that a purchase money lender who suspects that a debtor is likely to default has little to lose by threatening the debtor with repossession. Either the debtor will pay the amount due, or the threats will force him to declare bankruptcy. If the debtor files for bankruptcy, the lender who has refused to refinance at least retains his purchase money priority and may reclaim the collateral; a lender whose interest has been transformed by refinancing will usually receive nothing in liquidation. See notes 18-19 *supra*.

It may be argued that a consumer debtor is unlikely to declare bankruptcy, and a consumer creditor is unlikely to file an involuntary petition, over the kinds of small debts covered by § 522(f). However, there is always the prospect that some debtors may be forced into bank-

refinancing under the rule. The lender can just as easily extend payments under the old loan as well as issue a new loan."¹²¹ Other courts, however, have disagreed.¹²²

At the outset, it is unclear what the *Matthews* court would consider a proper extension of payments. In responding to Transamerica's argument that its refinancing constituted a renewal, the *Matthews* court relied partly on a California case characterizing a refinancing as a novation because "the new obligation had a different maturity date and a different rate of interest from the original loan."¹²³ It is not evident how the extension of time contemplated in *Matthews* differs in this regard: any refinancing will be evidenced by a separate piece of paper bearing a different date, and any refinancing will alter the terms of the original obligation in some way.¹²⁴ Indeed, if neither the maturity date nor the interest rate is changed, there is no reason to refinance. Uncertainty about the scope of the transformation rule, and the prospect of inconsistent interpretations of the rule in different jurisdictions, can only serve to magnify lenders' reluctance to refinance.

Apart from uncertainty as to time-extension refinancings, the possibility of avoiding the transformation rule by extending payments on existing accounts rather than issuing new notes may not prove satisfactory. Consolidation refinancings will still lose purchase money status under the rule. Consequently, lenders will have to isolate different accounts with the same debtor and treat them separately. This additional burden would have at least some impact, especially on small lenders.¹²⁵

Even assuming that time-extension refinancings fall outside the *Matthews* transformation rule,¹²⁶ it still does not follow that lenders can escape the rule's harmful effects. Time extensions would leave the

ruptcy by a creditor who fears that refinancing will be followed by bankruptcy and, for him, a financially inferior distribution of the debtor's assets.

121. *In re Matthews*, 724 F.2d 798, 801 n.5 (9th Cir. 1984).

122. See, e.g., *In re Gayhart*, 33 Bankr. 699, 701 (Bankr. N.D. Ill. 1983) ("Strictly applying the Transformation Rule would yield the undesirable result of discouraging creditors from refinancing consumer loans.").

123. 724 F.2d at 801. The *Matthews* court was referring to *Childs v. Stocker-LaBrea Properties*, 9 Cal. App. 3d 276, 88 Cal. Rptr. 34 (1970). In *Childs*, the California Court of Appeals held that a note given to pay interest due under prior notes secured by real property was not itself secured by real property. While the court mentioned that the maturity dates and interest rates differed, it first observed that the original notes were explicitly secured by a trust deed but were not guaranteed, while the note given to pay interest on the original notes did not indicate any real property as security, but did bear personal guarantees. Although the note in issue was one consolidating two separate notes given to pay interest, this fact seems to have played no part in the court's decision.

124. In *In re Gayhart*, 33 Bankr. 699 (Bankr. N.D. Ill. 1983), for example, the court acknowledged that a strict application of the transformation rule would invalidate the simple time-extension refinancing at issue there. Although refusing to reject the rule, it declined to apply it in that case because of its "unintended and inequitable results." 33 Bankr. at 700.

125. See note 80 *supra*.

126. See notes 121-24 *supra* and accompanying text.

lender with a delinquent account on the books,¹²⁷ a situation lenders seek to avoid.¹²⁸ Lenders will therefore resist this approach, especially in light of the uncertainty as to what form of refinancing would survive under a strict application of *Matthews*.¹²⁹

Lenders thus must choose between refusing to refinance and refinancing and losing purchase money status.¹³⁰ The former option is unsatisfactory to debtors because it accelerates the very repossession process Congress wished to forestall,¹³¹ and because it may well result in bankruptcies that could otherwise have been avoided.¹³² It is also unsatisfactory to lenders, who would rather have a solvent debtor.¹³³ The latter solution — that of refinancing and losing purchase money priority¹³⁴ — is unsatisfactory because lenders as a group will compensate for their increased economic exposure by making credit both more difficult and more expensive to obtain.¹³⁵ In addition, the debtor typically would gain little more than the extension of time and the reduction of payments that would have been freely given in the absence of the transformation rule. Of course, in a subsequent bankruptcy, the debtor is advantaged by the fact that she may avoid the lender's transformed security interest and retain her exempt property. However, the gain is comparatively small, since under section 722 the debtor would have been able to limit the effect of the security interest even if that interest had retained its purchase money status.¹³⁶

The transformation rule thus imposes burdens on both lenders and debtors that are not otherwise present. It gives the lender two options,

127. The *Matthews* court noted that by writing a new note, Transamerica "converted a delinquent loan into a current loan on its books." 724 F.2d at 800. The court concluded that the loss of purchase money status was the price Transamerica had decided to pay for this benefit.

128. Lenders try to avoid carrying delinquent accounts on their books because a high percentage of past-due accounts is thought to indicate bad credit management and to demonstrate the need for more selectivity in granting credit. See Cole, *supra* note 1, at 495-96. A retailer who wishes to negotiate her accounts receivable to a sales finance company will also receive less if her books show a large number of delinquent accounts.

129. See text following note 124 *supra*.

130. Other creditor options, such as garnishment, may not be adequate to safeguard the creditor's financial stake, and may, indeed, have consequences for the debtor as bad as or worse than either repossession or bankruptcy. See generally S. RIESENFELD, CASES AND MATERIALS ON CREDITORS' REMEDIES AND DEBTORS' PROTECTION 177-83 (1967).

131. See note 120 *supra* and accompanying text.

132. See note 140 *infra*.

133. Lenders would prefer to have a solvent debtor who continues to make payments but at a slower rate. As the *Matthews* court acknowledged, "[n]either party desires default." *In re Matthews*, 724 F.2d 798, 801 n.5 (9th Cir. 1984). Of course, lenders are injured when they are forced to extend the time for payments. See note 128 *supra*. However, lenders will ordinarily prefer to accept delinquent payments rather than repossess depreciated consumer goods. See note 35 *supra* and accompanying text.

134. This is the solution that the *Matthews* court envisioned for lenders who do not wish to carry delinquent accounts on their books. See note 127 *supra*.

135. See notes 117-19 *supra* and accompanying text.

136. See notes 40-41 *supra* and accompanying text.

neither of which is as satisfactory to both parties as the simple solution of retaining purchase money status after refinancing. The lender's most likely response is to restrict credit to compensate for its diminished security position.¹³⁷ This may be done either by diminishing the number of loans made initially¹³⁸ or by restricting refinancings.¹³⁹ In a system whose first goal is to keep debtors out of bankruptcy, neither result is desirable.¹⁴⁰ To the extent that Congress wishes to affect lending practices outside of the bankruptcy context,¹⁴¹ the bankruptcy laws are a clumsy and inappropriate vehicle. If courts wish to affect lenders' actions by means of the bankruptcy laws, ma-

137. This and a number of other possible creditor responses, including taking greater security and raising interest rates, are discussed in White, *The Recent Erosion of the Secured Creditor's Rights Through Cases, Rules and Statutory Changes in Bankruptcy Law*, 53 Miss. L.J. 389, 417-29 (1983).

There is evidence that lenders reacted to the increase in bankruptcy petitions that followed enactment of the 1978 Code by cutting back sharply on consumer credit. See CREDIT RESEARCH CENTER, KRANNERT GRADUATE SCHOOL OF MANAGEMENT, PURDUE UNIVERSITY, CONSUMERS' RIGHT TO BANKRUPTCY: ORIGINS AND EFFECTS (1982) (the "Purdue Study"). Some states attributed this rise to the new, more liberal federal exemptions and opted out of the federal scheme. See, e.g., JOINT STATE GOVERNMENT COMMISSION OF PENNSYLVANIA, BANKRUPTCY EXEMPTIONS 11-12 (1982); see also note 13 *supra*. The Purdue study's methodology and objectivity have been seriously questioned, however, see Sullivan, Warren & Westbrook, *Limiting Access to Bankruptcy Discharge: An Analysis of the Creditors' Data*, 1983 Wis. L. REV. 1091, as has the link between any increase in filings and the new exemptions, see Woodward & Woodward, *Exemptions as an Incentive to Voluntary Bankruptcy: An Empirical Study*, 57 AM. BANKR. L.J. 53 (1983).

138. See notes 117-19 *supra* and accompanying text.

139. See notes 120-29 *supra* and accompanying text.

140. Refinancing an old debt or extending a new advance may well allow the debtor to remain solvent. In fact, a report sponsored by the Office of Consumer Affairs recommends refinancing and extending payments as responsible practices that lenders should undertake when possible. OFFICE OF CONSUMER AFFAIRS, U.S. DEPT. OF COMMERCE, CREDIT & FINANCIAL ISSUES: RESPONSIVE BUSINESS APPROACHES TO CONSUMER NEEDS 15 (1981). The importance of refinancing is illustrated by one study suggesting that unexpected medical expenses are a major cause of bankruptcy. See *Personal Bankruptcy: Oversight Hearings Before the Subcomm. on Monopolies and Commercial Law of the House Comm. on the Judiciary*, 97 Cong., 1st & 2d Sess. 68-69 (1981-82) (statement of Philip Shuchman, author of the "Connecticut Study"). The same study showed that most debtors were employed when they filed for bankruptcy. *Id.*, at 66. These results imply that a rescheduling of existing debt, possibly coupled with an advance that pays the unexpected medical bills and effectively consolidates them with the preexisting debt, would be a realistic way for the debtor to remain out of bankruptcy. On the other hand, if either the creditor holding the outstanding debt or the medical provider elects to sue the defaulting debtor, bankruptcy is likely; almost half of the debtors studied had been involved in lawsuits prior to bankruptcy. Of these, over half were consumer credit suits, and another quarter were for unpaid medical expenses. *Id.* The impact of a consumer credit suit is especially severe because virtually all consumer credit contracts contain acceleration clauses that make the entire debt due on default. See G. GILMORE, *supra* note 79, ¶ 43.4, at 1195.

The Connecticut Study findings are consistent with another study that found medical expenses and prior debt consolidation to be the reasons most often given for personal loans. See FEDERAL RESERVE STUDY, *supra* note 1, at 80.

141. There is no evidence that this was their intent in passing the bankruptcy laws, especially since those federal laws dealing directly with consumer credit have carefully protected purchase money financing security. See, e.g., FTC Trade Regulation on Credit Practices, 16 C.F.R. § 444.2(a)(3) (1985).

nipulation of U.C.C. categories is an even more inappropriate tool.¹⁴²

CONCLUSION

Neither the language of the U.C.C. nor the policies of the U.C.C. or the Bankruptcy Code support the transformation rule. The rule as adopted by the Ninth Circuit discourages both lending and refinancing, and needlessly complicates consumer credit transactions. The better rule assumes that refinancing does not change the character of a security interest unless a clear intent to the contrary is shown.

— *Raymond B. Check*

142. The U.C.C. specifically "does not prescribe regulations and controls which may be necessary to curb abuses arising in the small loan business or in the financing of consumer purchases on credit." Note to U.C.C. § 9-102, 3 U.L.A. 77 (1981). This was a thoroughly debated decision on the part of the drafters, who ultimately intended to leave this type of regulation to other, more specific statutes. See GILMORE, *supra* note 79, ¶ 9.2, at 293.