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

JULIET M. MORINGIELLO*

"Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding."[1]

I. INTRODUCTION

"State law governs property rights in bankruptcy." "State law governs claims in bankruptcy." For years, courts have made statements similar to these, relying on two U.S. Supreme Court cases: *Butner v. United States*[2] and *Vanston Bondholders Protective Committee v. Green*.[3] In those cases, the Court held that state law governs property rights and claims in bankruptcy unless a compelling federal interest dictates otherwise.[4] Under both the Bankruptcy Code of 1978[5] (the Code) and its predecessor, the Bankruptcy Act of 1898[6] (the Act), courts and scholars have wrestled with the problem of finding the proper balance between federal law and state law in bankruptcy cases.[7]

---

* Associate Professor, Widener University School of Law. B.S.F.S., Georgetown University, J.D., Fordham University, LL.M., Temple University. I would like to thank my research assistants, Kerry Duffy and Ericka Hernandez, for all of their hard work on this article. Thanks also to Nick Nichols for his helpful comments on an earlier draft.

1. Butner v. United States, 440 U.S. 48, 55 (1979).
2. *Id*.
3. 329 U.S. 156 (1946).
4. *Butner*, 440 U.S. at 56; *Vanston*, 329 U.S. at 161.
5. 11 U.S.C. §§ 101-1330 (1994).
6. Act of July 1, 1898, ch. 541, 30 Stat. 544 (repealed 1978).
7. *See, e.g.*, Vern Countryman, *The Use of State Law in Bankruptcy Cases (Part I)*, 47 N.Y.U. L. REV. 407 (1972) [hereinafter Countryman I]; Vern Countryman, *The Use Of State Law in Bankruptcy Cases (Part II)*, 47 N.Y.U. L. REV. 631 (1972) [hereinafter Countryman II]. Courts have addressed the question of whether a bankruptcy court can impose a constructive trust and whether property subject to a constructive trust becomes property of the bankruptcy estate. *See, e.g.*, XL/Datacomp v. Wilson (*In re* Omegas Group, Inc.), 16 F.3d 1443, 1453 (6th Cir. 1994) (denying bankruptcy courts the power to impose a constructive trust); *In re* Columbia Gas Sys., Inc., 997 F.2d 1039, 1062 (3d Cir. 1993) (imposing a constructive trust and excluding it from the bankruptcy estate); Mullins v. Burtch (*In re* Paul J. Paradise & Assocs., Inc.), 249 B.R. 360, 371 (D. Del. 2000) (looking

Section 522(f) of the Code begs an answer to the question of whether state law or federal law defines property rights in bankruptcy. This provision allows an individual debtor to avoid a non-possessory, non-purchase-money security interest in certain listed household goods to the extent that the security interest impairs an exemption to which the debtor is otherwise entitled.[8] Section 522(f) promotes an important consumer protection policy of dissuading creditors from taking security interests in items necessary for debtors' day-to-day lives, such as kitchen appliances and furniture.[9] Congress recognized, however, that some security interests in necessities were not inherently bad. Consequently, § 522(f) prohibits a debtor from invalidating a security interest given to secure a loan for the purchase price of the goods.[10]

Congress failed to define the term "purchase-money security interest" in the Code, thus leaving the question to judicial interpretation. Courts forced to interpret the term have turned to a mixture of federal policy and state law to define the term. Most courts begin with the relevant state enactment of Article 9 of the Uniform Commercial Code (U.C.C.); however, the U.C.C. does not provide much guidance. Under the U.C.C., purchase-money status is not clear in two instances: when a consumer debtor refinances a purchase-money loan and when a consumer debtor adds debt and collateral to an existing purchase-money obligation, such as a revolving department store charge.[11] Of course, courts do not address the clear cases, and courts have defined the term "purchase-money security interest" in a variety of ways in the questionable cases involving refinanced debt and add-on debt.[12]

This article urges a federal codification of the term "purchase-money security interest" in §522(f). The problem is ripe for a federal solution because the drafters of Revised Article 9 of the U.C.C. expressly refused to resolve the question of whether the purchase-money character of a security interest in consumer goods can survive refinancing or consolidation.[13]

---

to state law to determine if and when constructive trust arose); EBS Pension, L.L.C. v. Edison Bros. Stores, Inc. (*In re* Edison Bros., Inc.), 243 B.R. 231, 237 (Bankr. D. Del. 2000) (applying federal common law to determine whether a constructive trust arose). Further, courts have addressed whether a liquor license is property for bankruptcy purposes. *See, e.g., In re* Terwilliger's Catering Plus, 911 F.2d 1168, 1172 (6th Cir. 1990) (holding that liquor license is property for bankruptcy purposes, even though state courts had held that liquor license constitutes a privilege carrying neither contract nor property rights); Jackson v. Miller (*In re* Jackson), 93 B.R. 421, 423 (Bankr. W.D. Pa. 1988) (holding that because Pennsylvania law in effect at time deemed liquor license to be privilege, liquor license was not property of debtor for bankruptcy purposes).

8. 11 U.S.C. §522(f)(1)(B)(i) (1994).
9. H.R. REP. NO. 95-595, at 126-27 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6087-88.
10. 11 U.S.C. §522(f).
11. *See infra* Part II.
12. *See infra* Part III.
13. U.C.C. §9-103 cmt. 8 (2000). The refusal to define the term "purchase-money security

Several bankruptcy reform bills have been introduced and even passed in Congress over the past several years, but while those bills addressed some perceived problems with § 522(f), none of the bills defined the term "purchase-money security interest."[14] Therefore, the Code continues to leave the definition of the term to disparate judicial interpretations leading to non-uniform application of § 522(f).

There are several reasons why Congress should define the term "purchase-money security interest" in the Code. First, allowing judicial definitions of the term "purchase-money security interest" leads to uncertainty, which is undesirable from both a bankruptcy law and commercial law perspective. In addition, in a consumer goods transaction, purchase-money status is irrelevant outside of bankruptcy. A federal solution to the problem is appropriate and within Congress' constitutional authority to establish "uniform Laws on the subject of Bankruptcies throughout the United States."[15] The Bankruptcy Code already modifies numerous property rights. In fact, § 522(f) allows a debtor to set aside a security interest that would be valid under state law.[16] Congress has already refined § 522(f) once to eliminate a perceived ambiguity in the statute and has clarified other property rights under the Code.[17] Finally, because of the policies underlying

---

interest" in consumer goods transactions was a result of a national consumer compromise in the Revised Article 9 drafting process. Jean Braucher, *Deadlock: Consumer Transactions Under Revised Article 9*, 73 AM. BANKR. L.J. 83, 83 (1999). *See infra* notes 331-34 and accompanying text.

14. *See, e.g.*, H.R. 333, 107th Cong. § 313 (2001) (changing definition of "household goods" to conform to FTC Credit Practices Rule) (passed in the House of Representatives Mar. 1, 2001).

15. Butner v. United States, 440 U.S. 48, 54 (citing U.S. CONST. art. I, § 8 cl.4).

16. 11 U.S.C. § 522(f) (1994). In addition, the trustee in bankruptcy has the right to set aside security interests that would otherwise be valid outside of bankruptcy by using the strong-arm power. *Id*. § 544. Additionally she possesses the power to avoid preferential transfers, which would otherwise be valid under state law. *Id.* § 547(b).

17. *See generally* Lawrence Ponoroff, *Exemption Impairing Liens Under Bankruptcy Code Section 522(f): One Step Forward and One Step Back*, 70 U. COLO. L. REV. 1 (1999); *infra* notes 217-98 and accompanying text.

In fact, the specific holding of *Butner*, that a mortgagee's right to the rents from mortgaged property in the property owner's bankruptcy is a question of state, not federal law, *Butner*, 440 U.S. at 54, was superceded by the 1994 Amendments to the Code. In *Butner*, a case arising under the Bankruptcy Act of 1898, the Court addressed whether the rights to the rents collected during the period between the mortgagor's bankruptcy petition and the foreclosure sale of the mortgaged property was determined by state law or a federal rule of equity. *Id*. at 49. Under the applicable state law, the mortgagee's right to the rents was dependent upon his taking possession of the property. *Id*. at 51. The mortgagee in *Butner* had not taken possession of the property prior to the bankruptcy petition, but nevertheless claimed a security interest in the rents held by the trustee in bankruptcy. *Id.*

Two circuits had adopted a federal rule of equity that gave the mortgagee the rents and profits whether state law would have or not. *Id*. at 53 (citing *In re* Pittsburgh-Diquesne Dev. Co., 482 F.2d 243 (3d Cir. 1973); *In re* Wakey, 50 F.2d 869 (7th Cir. 1931); Bindseil v. Liberty Trust Co., 248 F.112 (3d Cir. 1917). Those courts reasoned that because the bankruptcy court had the power to prevent the mortgagee from exercising its state law remedy, thus depriving the mortgagee of the rents, the right to

consumer bankruptcy law, the problem of defining purchase-money security interests is one that needs a national solution.

II. A HOLE IN THE SEAM BETWEEN THE BANKRUPTCY CODE AND THE UCC: § 522(f)

A security interest is unquestionably a purchase-money security interest in two scenarios. When a debtor borrows money to buy a specific consumer good, there is no question that the resulting security interest is a purchase-money security interest. As a result, when a consumer (Debtor 1) goes to Sears, buys a washing machine for home use and charges the washing machine on his secured Sears charge, Sears is unquestionably a purchase-money secured creditor. If another consumer (Debtor 2) obtains a loan from Finance Co. to buy the same washing machine at Sears and grants Finance Co. a security interest in the washing machine, Finance Co. is also clearly a purchase-money secured creditor. Under both Former Article 9 of the U.C.C. and Revised Article 9, a security interest is a purchase-money security interest to the extent it is given to secure the purchase price of the collateral.[18]

At the other end of the spectrum is the security interest that clearly is not purchase-money, such as one given by a consumer (Debtor 3) who offers her fully paid living room furniture to Finance Company as collateral for a loan. Rules promulgated by the Federal Trade Commission have made the kind of security interest granted by Debtor 3 rare.[19] As a result, the debtor's power to avoid non-possessory, non-purchase-money security interests in certain consumer goods is not generally used to avoid this kind of security interest.

In two other scenarios, a creditor's purchase-money status is anything but clear. When Debtor 1 purchases a stereo system with his Sears charge a month after he buys the washing machine, a question arises as to whether

---

rents should be a question of federal law, not state law. *Id.* Courts in five other circuits had held that the right to rents was a question of state law, even in bankruptcy. *Id*. at 52. The Court, while recognizing that Congress could adopt a rule regarding the right to rents in bankruptcy, sided with the majority of the circuits, which had held that the right to rents was a matter of state law, not federal law. *Id*. at 54.

The 1994 Amendments to the Code amended § 552 to provide that a mortgagee's security interest in real property continues in postpetition rents as long as the mortgage covered rents. 11 U.S.C. § 552 (1994).

18. U.C.C. §9-103(a), (b) (2000); Former U.C.C. §9-107 (1995). In this article, the 1995 Official Text of Article 9 of the U.C.C. will be referred to as "Former Article 9" and its sections will be cited as "Former U.C.C. §9-xxx." The 2000 Official Text will be referred to as "Revised Article 9" and its sections will be cited as "§9-xxx."

19. FTC Credit Practices Rule, 16 C.F.R. §444.2 (1999). The property listed in this regulation is slightly different from the property listed in §522(f) of the Code, so in rare cases a lender might take a security interest in fully paid for property. *Id.*

Sears has a purchase-money security interest in the stereo and the washing machine. When Debtor 2 and Finance Company refinance the original loan to extend the time for payment and enable Debtor 2 to borrow more money, a question arises as to whether Finance Company retains its purchase-money security interest in the washing machine. Courts have addressed these questions in numerous cases and have come to a variety of conclusions. The question is uniquely a bankruptcy question because of § 522(f), and bankruptcy courts generally apply either the transformation rule or the dual-status rule, explained below, to determine the extent of a purchase-money security interest.

Because the Code does not define "purchase-money security interest," courts look to state law for a definition. The state law definition of purchase-money security interest is found in each state's enactment Article 9 of the U.C.C. A new version of Article 9 (Revised Article 9) became effective in most states on July 1, 2001,[20] but the new version of Article 9 sheds no light on the proper definition to be applied in bankruptcy.

The former version of Article 9 (Former Article 9) states that a security interest is a purchase-money security interest to the extent that it secures the purchase price of the collateral.[21] Revised Article 9 clarifies the definition of purchase-money security interest in non-consumer transactions by providing that the purchase-money nature of a security interest is not lost by a refinancing or by the addition of debt or collateral.[22] Under Revised Article 9, a security interest can be partially purchase-money and partially non-purchase-money, and § 9-103 provides a method for determining the extent of the creditor's purchase-money security interest.[23] Parties are free to contractually allocate payments on the loan to the purchase-money and non-purchase-money portions of the loan in any reasonable manner, and if the contract does not provide an allocation method, the U.C.C. provides a first-in, first-out method.[24] As a result of a consumer compromise during the drafting process, however, consumer goods transactions are excepted from

20. U.C.C. §9-701 (2000). All 50 states and the District of Columbia have adopted Revised Article 9. Alabama, Connecticut, Florida, and Mississippi enacted their bills with delayed effective dates, with the Connecticut law becoming effective on October 1, 2001, and the remaining states' bills becoming effective on January 1, 2002. *See* National Conference of Commissioners on Uniform State Laws, *at* http://www.nccusl.org/nccusl/uniformact_factsheets/uniformacts-fs-ucca9asp (last visited Oct. 26, 2001).

21. Former U.C.C. § 9-107. Some states adopted non-uniform versions of Former U.C.C. §9-107. *See, e.g.*, N.C. GEN. STAT. § 25-9-107 (1999), which states that a purchase-money security interest will continue in collateral when the loan secured by the collateral is refinanced.

22. U.C.C. § 9-103(f).

23. *Id*. § 9-103(e).

24. *Id*.

the clarification. Thus, under Revised Article 9, the definition of a purchase-money security interest in consumer goods is left to case law.[25] The Official Comment to § 9-103 states that "[the] Bankruptcy Code does not expressly adopt the state law definition of 'purchase-money security interest.'"[26] The Code, however, does not have its own definition of the term, and none of the reform bills that Congress has considered during the past few years contain a definition. The Official Comment curiously adds that where federal law does not defer to Article 9 of the U.C.C., Article 9 does not determine a question of federal law.[27] So, again, the question of which code defines property rights is left wide open. The question is complicated by the fact that federal courts routinely use state law, the U.C.C., to determine the extent of a purchase-money security interest[28] and, using that uniform law, come to two very different conclusions.

III. PURCHASE-MONEY SECURITY INTERESTS, ACCORDING TO THE FEDERAL COURTS

In an add-on case involving a debtor like Debtor 1 above, the debtor, trying to avoid a lien under § 522(f), will argue either that the creditor has a purchase-money security interest only in the goods most recently bought under the sales and financing contract or that the creditor has no purchase-money security interest at all. The creditor, on the other hand, will argue that

---

25. U.C.C. § 9-103(e), (f), (h) (2000). Subsection (h) instructs courts not to infer from the exclusion of consumer goods transactions the proper rule in such transactions and allows the courts to continue to "apply established approaches." The exclusion of consumer transactions from the clarification and the allocation formula in § 9-103 is the result of the Article 9 drafters' consumer compromise. For a discussion of the consumer compromise and the events leading to the compromise, see Marion W. Benfield, Jr., *Consumer Provisions in Revised Article 9*, 74 CHI.-KENT L. REV. 1255 (1999); Edward J. Janger, *Predicting When the Uniform Law Process Will Fail: Article 9, Capture, and the Race to the Bottom*, 83 IOWA L. REV. 569, 612-13 (1998); Fred H. Miller, *Consumers and the Code: The Search for the Proper Formula*, 75 WASH. U. L.Q. 187 (1997); *infra* notes 331-34 and accompanying text.

26. U.C.C. § 9-103 cmt. 8 (2000).

27. *Id.*

28. *See, e.g.*, Billings v. Avco Colo. Indus. Bank (*In re* Billings), 838 F.2d 405, 406 (10th Cir. 1988) ("For [the] definition [of purchase security interest], the courts have uniformly looked to the law of the state in which the security interest is created."); Pristas v. Landaus of Plymouth, Inc. (*In re* Pristas), 742 F.2d 797, 800 (3d Cir. 1984) ("The Bankruptcy Act [sic] does not define 'purchase-money security interest.' Therefore, we look to state law."); Roberts Furniture Co. v. Pierce (*In re* Manuel), 507 F.2d 990, 992 (5th Cir. 1975) ("The issue here is whether Georgia law would allow the arrangement below to be considered a Purchase Money Security Interest . . . ."); *In re* Hillard, 198 B.R. 620, 622 (Bankr. N.D. Ala. 1996) ("The definition of purchase money security interest is not contained in the Bankruptcy Code. Accordingly, the Court must consider relevant state law to determine whether [the secured creditor] lost its purchase money security interest in the debtors' household goods . . ..").

its security interest extends to all goods purchased under the contract, regardless of when bought. In a refinancing case, involving a debtor like Debtor 2 above, the debtor will argue that any new money advanced by the creditor renders the entire loan non-purchase-money. In both types of cases, most courts apply one of two rules to determine the extent of the creditor's purchase-money security interest, the transformation rule or the dual-status rule. Under the transformation rule, the more debtor-friendly of the two, a purchase-money security interest is transformed into a non-purchase-money security interest upon a refinancing or an addition of debt or collateral.[29] The dual-status rule, the more creditor-friendly of the two, allows the courts to separate the security interest into purchase-money and non-purchase-money components.[30] Although commentary regarding the relative merits of both rules[31] will not be repeated here, it is useful to illustrate how those rules have been applied in order to demonstrate that the resolution should be found in federal bankruptcy law, not in state commercial law.

A. Transformation Rule Cases

Courts have applied the transformation rule to deny the secured creditor purchase-money status in both refinancing cases and cases involving add-on debt. Some of these courts rely primarily on the language of Former § 9-107 and its Official Comment, some rely primarily on the language and policy of the Code, and others appear to rely on a combination of the two. Yet another group of courts applies the transformation rule based on the intent of the parties to the loan agreement.

1. State Law Governs

The decision in *Matthews v. Transamerica Financial Services*[32] illustrates the reasoning applied by courts which rely primarily on state law. The *Matthews* facts are typical of add-on debt cases. In *Matthews*, the debtors wished to avoid a security interest in a piano and a stereo under § 522(f) of

29. *Hillard*, 198 B.R. at 622; *see infra* Part II.A.

30. *Hillard*, 198 B.R. at 623; *see infra* Part II.B.

31. *See, e.g.*, David Gray Carlson, *Purchase Money Under the Uniform Commercial Code*, 29 IDAHO L. REV. 793 (1992-93); Russell A. Hakes, *According Purchase Money Status Proper Priority*, 72 OR. L. REV. 323 (1993); Ann E. Conaway Stilson, *The "Overloaded" PMSI in Bankruptcy: A Problem in Search of a Resolution*, 60 TEMP. L.Q. 1 (1987). For a discussion of the dual-status rule from the consumer standpoint, see Gail Hillebrand, *The Uniform Commercial Code Drafting Process: Will Articles 2, 2B and 9 Be Fair to Consumers?*, 75 WASH. U. L.Q. 69, 127-30 (1997).

32. 724 F.2d 798 (9th Cir. 1984).

the Bankruptcy Code.[33] Transamerica financed the purchase of those items and 13 months later the debtor and Transamerica refinanced the loan.[34] As a result of the refinancing, Transamerica advanced about $300 of new money and extended the term of the loan.[35] Thirteen months after the refinancing, Mr. and Mrs. Matthews filed for bankruptcy.[36] Soon afterwards, Transamerica filed a motion for relief from the automatic stay in order to repossess the collateral.[37] The debtors cross-complained for avoidance of Transamerica's security interest.[38] In denying Transamerica purchase-money status (and thus allowing the debtors to avoid the security interest), the court focused on the language of the Official Comment to Former § 9-107, which states that the section "excludes from the purchase-money category any security interest taken as security for or in satisfaction of a pre-existing claim or antecedent debt."[39] Because the loan documents stated that the purpose of the new loan was to pay off the old purchase-money loan, the court found that Transamerica intended to make a new loan rather than to simply extend payments on the purchase-money loan.[40] The court characterized purchase-money status as "an exceptional category . . . 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."[41]

Some courts apply the transformation rule without resorting to the Official Comment to Former § 9-107, instead finding support for the transformation rule in the statute itself. *Roberts Furniture Co. v. Pierce* (*In re Manuel*),[42] a pre-Code case applying Georgia law to a case involving add-on debt, provides an example of such reasoning. The creditor in *Manuel* claimed that it had a valid security interest in the debtor's property.[43] In order for a security interest to survive a debtor's bankruptcy filing, the security interest must be perfected; however, the creditor in *Manuel* had not filed a financing

33. *Id*. at 799.
34. *Id*.
35. *Id*.
36. *Id*.
37. *Id*.
38. *Id*.
39. *Id*. at 801 (quoting CAL. COM. CODE § 9107, U.C.C. cmt.2 (West 1964)). Several other courts have relied on the same language in Official Comment 2 to deny purchase-money status to creditors in both refinancing and add-on cases. *In re* Jones, 5 B.R. 655, 657 (Bankr. M.D.N.C. 1980) (involving refinanced debt); Mulcahy v. Indianapolis Morris Plan Corp. (*In re* Mulcahy), 3 B.R. 454, 457 (Bankr. S.D. Ind. 1980) (involving add-on debt).
40. *Matthews*, 724 F.2d at 801.
41. *Id*.
42. 507 F.2d 990 (5th Cir. 1975).
43. *Id*. at 992.

statement.[44] Because the collateral consisted of consumer goods, if the security interest had been purchase-money, the creditor would have perfected its interest without filing.[45] The Fifth Circuit held that the creditor's failure to file rendered it unperfected.[46] The court focused on the language in Former § 9-107, which states that a security interest is purchase-money to the extent that it is "taken or retained by the seller of the collateral to secure all or part of its price."[47] Unlike the courts that focus on the "to the extent" language of Former § 9-107 to support the dual-status rule, the *Manuel* court focused on the requirement in Former § 9-107 that the seller take or retain a purchase-money security interest to secure the price of the collateral.[48] Because the security interest at issue in *Manuel* extended to several items of furniture and a television set bought by the debtor on different dates, the court held that the security interest was transformed into a non-purchase-money interest because it was not taken or retained by the seller solely to secure the purchase price of the collateral.[49]

2. Federal Law Governs

At the other end of the spectrum are the courts which rely almost solely on federal law and policy to justify their use of the transformation rule to deny a secured lender purchase-money status. The Fourth Circuit's decision in *Dominion Bank of the Cumberlands v. Nuckolls*[50] provides an example of the reasoning of such courts. In *Nuckolls* the court applied the transformation rule and found that a refinanced loan was not a purchase-money loan in a case involving a debtor's tools of trade.[51] The court held that a refinancing destroyed a creditor's purchase-money status, relying primarily on *Matthews* and the plain language and legislative history of the Code.[52] The court stated that a lien given in connection with refinancing is not a purchase-money lien because it secures a loan made to refinance a preexisting debt, not a loan made to acquire the collateral.[53] In its decision, in which it made no reference to the Uniform Commercial Code's definition of purchase-money security interest, the court explained that §522(f) was included in the Code to

44. *Id*. at 992-93.
45. *Id*. at 993.
46. *Id*.
47. *Id*. (quoting GEORGIA CODE § 109A-9-302).
48. *Id*.
49. *Manuel*, 507 F.2d at 993.
50. 780 F.2d 408 (4th Cir. 1985).
51. *Id*. at 413.
52. *Id*.
53. *Id*.

preserve the debtor's right to a "fresh start."[54] The court also noted that while the primary concern of Congress in enacting § 522(f) was for consumers who enter into contracts of adhesion, the statute is not so limited.[55]

The court in *Haus v. Barclays American Corporation* (*In re Haus*)[56] appeared to rely solely on federal law when it adopted the transformation rule not by analyzing § 522(f) but by relying on bankruptcy cases from around the country. While the *Haus* court noted that the definition of purchase-money security interest was found in the U.C.C., the court relied solely on bankruptcy cases to define the extent of the creditor's purchase-money status.[57]

3. State and Federal Law Govern

Other courts appear to follow a combination of state and federal law to define the term "purchase-money security interest." The court in *In re Snipes*[58] stated that because the Code did not define purchase-money security interest, it would look to state law.[59] The court then quoted the definition of "purchase-money security interest" in the Missouri U.C.C.[60] While the court followed other bankruptcy courts sitting in Missouri in reaching its decision, it weighed the merits of both the transformation rule and the dual-status rule, as adopted by courts throughout the country, before settling on the transformation rule.[61]

The court in *In re Hillard*[62] followed a similar path of reasoning in a case involving refinanced debt. The court began its analysis by quoting the definition of purchase-money security interest in Alabama's U.C.C.[63] It then adopted the transformation rule not because Alabama courts had adopted such a rule, but because the Eleventh Circuit had adopted the transformation rule in an earlier bankruptcy case.[64] Although the earlier bankruptcy case, *Snap-On Tools, Inc. v. Freeman* (*In re Freeman*)[65] involved an Alabama

54. *Id*. (quoting S. REP. NO. 95-989, at 76 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5862).
55. *Id*.
56. 18 B.R. 413, 417 (Bankr. D.S.C. 1982) (addressing case in which creditor lost purchase-money status because of add-on debt).
57. *Id*. at 415, 417.
58. 86 B.R. 1006 (Bankr. W.D. Mo. 1988).
59. *Id*. at 1007.
60. *Id*. at 1007 (quoting MO. ANN. STAT, § 400.9-107 (West 1988)).
61. *Id*. at 1007-08.
62. 198 B.R. 620 (Bankr. N.D. Ala. 1996).
63. *Id*. at 622 (quoting ALA. CODE § 7-9-107 (1975)).
64. *Id*. at 623.
65. 956 F.2d 252 (11th Cir. 1992).

ebtor, the court in *Hillard* did not rely on Freeman as a statement of the applicable state law.[66]

4. The Terms of the Contract Govern

In cases involving contracts explicitly providing for cross-collateralization, some courts have applied the transformation rule, reasoning that a cross-collateralized security interest is not one retained by a seller of collateral solely to secure the purchase price of the collateral. The contract at issue in *W.S. Badcock Corp. v. Banks* (*In re Norrell*)[67] is typical of a cross-collateralized security agreement. In *Norrell* the debtor had purchased a number of household goods and granted the seller a security interest in the goods pursuant to a security agreement that contained the following clause:

> I hereby grant to Seller a security interest in the above described property and in all other items purchased from the seller . . . to secure the payment of my account balance, such security to remain in such property until the total cash price, and all FINANCE CHARGES, and insurance charges, if any, applicable thereto, and any subsequent purchases (plus any charges applicable thereto) added to this contract while there is a balance due thereon, have been paid in full.[68]

Debtors signed contracts containing similar language in *Manuel*[69] and in *Landaus of Plymouth, Inc. v. Scott* (*In re Scott*).[70] In *Scott* each contract added the balance due on the preceding contract to the total balance due and the contracts stated that when the purchased goods were fully paid they would serve as security for the payment of subsequent purchases.[71] In all of these cases, the courts held that the specific reservation of a security interest in fully paid goods rendered the entire security interest non-purchase-money.[72]

---

66. *Id*.
67. 426 F. Supp. 435 (M.D. Ga. 1977).
68. *Id*. at 436.
69. Roberts Furniture Co. v. Pierce (*In re* Manuel), 507 F.2d 990, 991 (5th Cir. 1975). In *Manuel*, the debtor purchased household items at two different times. *Id*. at 990. At the time of the second purchase, the seller added the purchase price of the second item to the outstanding purchase price of the first, and the debtor signed a security agreement providing that "[u]ntil all installment payments and all other amounts due hereunder, have been paid, Seller shall retain a security interest in the Goods . . . ." *Id*. at 992.
70. 5 B.R. 37, 38 (Bankr. M.D. Pa. 1980).
71. *Id*.
72. *Manuel*, 507 F.2d at 993; *Scott*, 5 B.R. at 39.

Although the contract in *Norell* was subject to a Georgia statute providing that payments on revolving accounts were to be applied first to the goods, which were first purchased, the court refused to find that such a statute released fully-paid items of collateral from the creditor's security interest.[73] The court held that the statute did not distinguish the case from *Manuel*, stating that the Georgia statute had "nothing to do with the creation, duration, definition or enforcement of purchase-money security interests in consumer goods."[74] Significantly, the court found that because the statute did not govern the termination of security interests contrary to the terms of a security agreement, the statute could not save the purchase-money status of a creditor under a security agreement providing for cross-collateralization.[75]

Courts applying the transformation rule in add-on cases often do so in cases in which the contract granting the security interest has no formula for allocating payments among goods bought under the contract. In some of these cases, the court concedes that the security interest can be both purchase-money and non-purchase-money, but only if the contract provides some method of allocating payments to the price of each item bought by the debtor.

For some courts, the absence of a contractual provision allocating payments to goods bought under the contract is essential to a holding that the transformation rule applies. In *Manuel*, the court noted that "[t]he problem here begins with the fact that the security agreement . . . shows . . . no clues as to what items are paid for and which are not."[76] The court in *Haus v. Barclays American Corp.* (*In re Haus*)[77] held that add-on debt rendered the entire security interest non-purchase-money.[78] The court stated that "if consumer goods secure any indebtedness other than their own and there is no formula for the application of the payments, the security interest in those goods is not a purchase-money security interest."[79] The court in *In re Shaw*[80] faced similar facts. Because the contract did not allocate payments under the contract to specific items of collateral, the court found that it was impossible to determine when each individual item of collateral was fully paid.[81] As a

73. 426 F. Supp. at 436.
74. *Id*.
75. *Id*. Federal courts in other states rely on similar statutes as evidence that the state has adopted the dual-status rule. *See infra* notes 97-113 and accompanying text.
76. *Manuel*, 507 F.2d at 993.
77. 18 B.R. 413 (Bankr. D.S.C. 1982).
78. *Id*. at 417.
79. *Id*.
80. 209 B.R. 393, 397 (Bankr. N.D. Miss. 1996).
81. *Id*.

result, the court allowed the creditor purchase-money status for only the most recently purchased collateral.[82]

Judges are justifiably reluctant to impose their own methods of allocation in the absence of contractual or legislative guidelines. The Eleventh Circuit refused to do so in *In re Freeman*,[83] a case in which a debtor sought to avoid a security interest in certain tools of his trade under § 522(f).[84] In *Freeman* the lender, Snap-On Tools, had financed the debtor's purchase of certain tools for his business.[85] Interestingly, the agreement at issue did provide for a first-in, first-out method of allocation, which the court refused to apply.[86] The court in *Freeman* found the contractual allocation formula too vague to be workable and applied the transformation rule in holding that Snap-On Tools' security interest was non-purchase-money and thus avoidable under § 522(f).[87]

While some courts will not impose judicially created allocation formulae, at least one court set forth guidelines regarding the contents of an acceptable contract, including a method for allocating payments among items purchased. The court in *Family Retail Services v. McCombs* (*In re McCombs*)[88] adopted the transformation rule and then gave an example of acceptable contract language.[89] It stated that language such as "payments will be applied first to Finance Charges, then to insurance premiums due, then to principal, in order of purchases," will save the creditor's purchase-money security interest.[90] In a sense, the court adopted a modified transformation rule because if a creditor followed the court's guidelines, the creditor would be able to retain its purchase-money security interest.

B. Dual-Status Rule Cases

Courts have applied the dual-status rule to preserve the creditor's purchase-money status in both consumer refinancing and add-on debt cases. Most of the courts adopting the dual-status rule appear to rely primarily on state law. Some courts mention bankruptcy policy to support their holdings, while others rely on the terms of the contract for support.

---

82. *Id*. The court was amenable to the dual-status rule, but only in cases in which the contract provided an allocation formula. *Id.*

83. 956 F.2d 252 (11th Cir. 1992).

84. *Id*. at 254.

85. *Id*. at 253.

86. *Id*. at 254-55.

87. *Id*. at 255.

88. 126 B.R. 611 (N.D. Ala. 1989).

89. *Id*. at 612.

90. *Id*. at 613.

1. State Law Governs

Courts basing their holdings on state law start their analysis by noting that because the Bankruptcy Code does not define "purchase-money security interest," it is necessary to find the definition in the Uniform Commercial Code.[91] Many of the courts adopting the dual-status rule hold that such a rule better effectuates the language in the U.C.C. (that a security interest is purchase-money to the extent that it is taken by a person making a loan which enables the debtor to buy the collateral securing the loan).[92]

Some courts base their holdings solely on state law. In Virginia, Former Article 9 of the U.C.C. contained a non-uniform provision relating to security interests in consumer goods.[93] Under this provision, a secured creditor could consolidate debts from two or more sales of consumer goods, but the creditor could retain its secured status only by complying with the non-uniform provision.[94] This provision contained an allocation formula and further stated that a security interest in consumer goods terminated when the consumer paid the debt incurred as to each item.[95] The statute gave the secured creditor the option of using a first-in, first-out method of allocation or one in which debts are paid in the same proportion as the original debts bore to one another.[96] The existence of this non-uniform provision led the court in *In re Leftwich*[97] to apply the dual-status rule in a case involving a secured creditor's objection to a Chapter 13 plan. It is interesting to note that

---

91. *See, e.g.*, Billings v. Avco Colo. Indus. Bank (*In re* Billings), 838 F.2d 405, 406 (10th Cir. 1988) (noting that "courts have uniformly looked to the law of the state in which the security interest is created" for the definition of "purchase money security interest"); Pristas v. Landaus of Plymouth, Inc., 742 F.2d 797, 800 (3d Cir. 1984) (looking to state law because Bankruptcy code does not define term).

92. *See, e.g.*, *Billings*, 838 F.2d at 408 ("The problem with [the transformation rule] is that it ignores the precise wording of the Uniform Commercial Code."); *Pristas*, 742 F.2d at 801 ("A purchase-money security interest in a quantity of goods can remain such 'to the extent' it secures the price of an item, even though it may also secure the price of other articles."); *In re* Hemingson, 84 B.R. 604, 607 (Bankr. D. Minn. 1988) ("The 'transformation rule' is misguided because it fails to consider the import of the critical language in section 9-107 - 'to the extent.'") (quoting *Pristas*, 742 F.2d at 801); *In re* Schwartz, 52 B.R. 314, 316 (Bankr. E.D. Pa. 1985) ("By overlooking [the phrase 'to the extent'] the 'transformation' courts adopt an unduly narrow view of the purchase-money security device."); Russell v. Associates Fin. Servs. Co. of Okla., Inc. (*In re* Russell), 29 B.R. 270, 273 (Bankr. W.D. Okla. 1983) ("The only way 'to the extent' can be given meaning is to find that a secured debt may be split into two parts, a purchase-money part . . . and a nonpurchase-money part . . . .").

93. VA. CODE ANN. § 8.9-204.1 (Michie 1991).

94. *Id.*

95. *Id.*

96. *Id.*

97. 174 B.R. 54, 60 (Bankr. W.D. Va. 1994).

irginia's non-uniform section was silent as to whether a creditor could retain its purchase-money status.[98]

Some states have consumer installment sales statutes which contain language similar to that relied on by the court in *Leftwich* and courts in some of those states rely on such statutes to support the dual-status rule. The Third Circuit in *Pristas v. Landaus of Plymouth, Inc.* (*In re Pristas*),[99] relied on such a statute to find that Pennsylvania had adopted the dual-status rule.[100] In *Pristas*, the debtor had bought a washer and a recliner in two separate transactions.[101] The contract in *Pristas* specifically stated that the seller retained a security interest in all of the goods purchased until the buyer made the final payment, that the seller could add the buyer's subsequent purchases to the amount financed, and that the goods purchased under each contract would be security for each subsequent purchase.[102] The contract did not contain a method for allocating the buyer's payments to the purchase prices for each of the goods.[103]

The Third Circuit, however, found an allocation provision in the Pennsylvania Goods and Services Installment Sales Act, which provides that if there is no express provision in the contract between the buyer and seller, "[e]ach payment . . . shall be deemed to be allocated to all of the various time sale prices in the same proportion or ratio as the original cash sales prices of the various purchases bear to one another."[104] This decision is contrary to the interpretation of a similar Georgia statute at issue in the *Norrell* case.[105] In *Pristas*, the court clearly relied on state law and held that a state statute, saying nothing about the creation or termination of security interests, served to override specific contract language stating that all goods purchased secured the price of all other goods purchased.[106] As a result, the court held that the lender had a purchase-money security interest to the extent of the unpaid purchase price of all goods bought under the contracts.[107]

Statutes such the Pennsylvania Goods and Services Installment Sales Act can allow the secured party to retain a purchase-money security interest in all goods sold in a series of transactions until the purchase price of all of the

98. *Id*. at 58 (citing VA. CODE ANN. § 8.9-204.1 (Michie 1991).
99. 742 F.2d 797 (3d Cir. 1984).
100. *Id*. at 802.
101. *Id*. at 798.
102. *Id*.
103. *Id.* at 798-99.
104. *Id*. at 802 (quoting PA. STAT. ANN. tit. 69, § 1802 (West 1984)).
105. 426 F. Supp. 435, 436 (M.D. Ga. 1977). *See supra* notes 67-75 and accompanying text.
106. *Pristas*, 742 F.2d at 802.
107. *Id*.

items is paid in full. *Breakiron v. Montgomery Ward* (*In re Breakiron*)[108] provides a good illustration of this point. The loan at issue in *Breakiron* arose from a revolving charge agreement.[109] Under that agreement, the seller, Montgomery Ward, retained a security interest in each item purchased under the agreement until the purchase price of that particular item was paid in full.[110] The revolving charge agreement contained an allocation method that was identical to the one provided by the Pennsylvania Goods and Services Installment Sales Act.[111] The court rejected the debtor's argument that such an allocation effectively created a security interest in all the items purchased until the entire loan is paid.[112] Instead, it held that because the contract stated that each item purchased was security for only its own debt and provided a method for allocating payments among the various items purchased, the purchase-money nature of Montgomery Ward's security interest survived.[113]

As the foregoing discussion illustrates, an allocation formula is essential to the application of the dual-status rule. The Uniform Consumer Credit Code (U3C)[114] provides a first-in, first-out allocation method,[115] and bankruptcy courts sitting in some of the states that have adopted the U3C have applied such an allocation method to loans involving refinancing and add-on debt. The court in *In re Russell*[116] did so and added that first-in, first-out proration avoids unconscionability charges because the first purchased items will be released first from the creditor's security interest.[117]

Other courts have supplied their own allocation formulae in the absence of a controlling statute. The court in *In re Gibson*[118] addressed six bankruptcy cases, some involving add-on debt and some involving refinanced debt. In some, the seller of the goods extended the debtor credit to purchase the goods, while in others, the debtor borrowed the money from a third-party lender.[119] The U3C, as enacted in Kansas, applied to the cases involving seller financing but not to those involving third-party financing. However, in the cases to which the U3C did not apply, the court applied a first-in, first-out

108. 32 B.R. 400 (Bankr. W.D. Pa. 1983).
109. *Id*. at 400.
110. *Id*. at 401.
111. *Id*. at 403.
112. *Id*.
113. *Id*.
114. UNIF. CONSUMER CREDIT CODE (1974).
115. *Id*. § 3.302.
116. 29 B.R. 270 (Bankr. W.D. Okla. 1983).
117. *Id*. at 274.
118. 16 B.R. 257, 259 (Bankr. D. Kan. 1981).
119. *Id*. at 260-61.

rule as well, in the interest of equity.[120] In *In re Short*[121] the court applied a first-in, first-out allocation formula to refinanced debt in the absence of contractual or legislative guidelines, stating that "courts of equity are peculiarly suited to the task of allocating payments."[122]

2. The Terms of the Contract Govern

Some courts focus on whether or not the debtor and creditor intended that a refinancing effect a novation of the existing obligation. This determination is key to a finding that the dual-status rule preserves the purchase-money status of a security interest. In *Billings v. Avco Colorado Industrial Bank* (*In re Billings*),[123] the Tenth Circuit rejected the transformation rule in a case involving debtors who had purchased furniture from the secured party and refinanced the loan after they had trouble making payments.[124] The parties executed a new note and security agreement that extended the time for repayment, increased the interest rate, and added less than ten dollars of new debt.[125] The court noted that one problem with the transformation rule is that "it ignores the possibility that the refinancing merely renewed the debt, rather than create a new debt."[126] Because Colorado courts had never addressed the issue of whether or not a refinancing extinguishes a purchase-money security interest, the *Billings* court looked to the Colorado law regarding novation.[127] The court then found that under the applicable state law, the issuance of a new note to refinance a debt did not automatically constitute a novation and that in the instant case, the parties did not intend for the new note to extinguish the original debt and security interest.[128]

For other courts, whether or not the debtor and creditor intended a novation is the only question. In two cases involving refinanced debt, *In re Hatfield*[129] and *In re Krueger*,[130] the courts refused to adopt either the transformation or dual-status rule, preferring instead to take a case-by-case approach to the issue. The *Hatfield* court pointed out deficiencies in both the

120. *Id*. at 268-69.
121. 170 B.R. 128 (Bankr. S.D. Ill. 1994).
122. *Id*. at 136.
123. 838 F.2d 405 (10th Cir. 1988).
124. *Id*. at 410.
125. *Id*. at 406.
126. *Id*. at 408.
127. *Id*. at 407.
128. *Id*. at 409.
129. 117 B.R. 387, 389-90 (Bankr. C.D. Ill. 1990).
130. 172 B.R. 572, 575 (Bankr. N.D. Ohio 1994).

transformation and dual-status rules.[131] According to *Hatfield* and the cases cited therein, the transformation rule is deficient because it could discourage creditors from refinancing consumer loans.[132] On the other hand, the dual-status rule is lacking in that it is sometimes unclear when any one item is paid off and released from the security agreement.[133] Under the case-by-case approach, courts should determine whether the refinancing should be characterized as a renewal of the original obligation or a novation.[134] If the refinancing agreement is just a renewal, as the court found the agreement in *Hatfield* to be, then the loan retains its purchase-money character.[135] The court's holding that the agreement was a renewal was buttressed by two important facts: the creditor advanced no additional funds to the debtor and the interest rate on the original obligation remained the same.[136]

In *Krueger*, the court relied on state law and noted that in Ohio, the renewal of a note does not create a new debt.[137] The refinanced note in *Krueger* not only added $1,000 to the indebtedness but it also changed the interest rate.[138] The court emphasized the fact that the note was refinanced only three months after the original loan was made.[139] Because of the short period of time between the original loan and the refinancing, the court reasoned that the lender could not have possibly intended to give up its purchase-money security interest.[140] The court noted the split among the bankruptcy courts between the dual-status rule and the transformation rule but discussed neither in detail.[141]

While the intent of the parties is critical in some decisions, it is irrelevant in others. In *In re Schwartz*,[142] the court acknowledged that the debtor and creditor did intend a novation because the refinancing involved a new security agreement and new money. Regardless of the novation, however, the court applied the dual-status rule to allow the creditor to keep its purchase-money security interest in the debtor's household goods.[143]

---

131. *Hatfield*, 117 B.R. at 390.
132. *Id*.
133. *Id*.
134. *Id*.
135. *Id*. at 391.
136. *Id*. at 390.
137. *Krueger*, 172 B.R. at 574.
138. *Id*.
139. *Id*. at 575.
140. *Id*.
141. *Id*. at 574.
142. 52 B.R. 314, 315 (Bankr. E.D. Pa. 1985).
143. *Id*. at 316-17.

3. Federal Policy Is Important

Some courts rely on federal policy to support their holdings that the dual-status rule should determine the extent of a purchase-money security interest. The courts in *Billings*, *Short*, *Gibson*, and *Russell* found that the dual-status rule better reflected the legislative history of the Bankruptcy Code.[144] All of those courts relied on the statement in the legislative history that the purpose of § 522(f) was to allow the debtor to "undo the consequences of a contract of adhesion, signed in ignorance, by permitting the invalidation of nonpurchase money security interests in household goods."[145]

In *Billings*, the court held that a creditor who refinances a debt is not committing the kind of overreaching that § 522(f) was designed to prevent because when a purchase-money loan is refinanced and the purchase-money collateral remains as security for the refinanced debt, the debt has not changed its "essential character."[146] In *Short*, another refinancing case, the court noted that the purpose of § 522(f) was to permit the avoidance of security interests in already-owned household goods, not to permit debtors to avoid security interests in the goods purchased with the original loan.[147]

C. The Other Cases

The Bankruptcy Court in Rhode Island has refused to take a position on whether the dual-status rule or the transformation rule applies in a § 522(f) case. The court in *Smiley v. Feldman Furniture Co.* (*In re Smiley*)[148] refused to choose either of the rules because the contract between the seller and the buyer allowed the seller to check a box continuing its security interest in the first-purchased item. Because the seller failed to check the box, the seller lost its prior security interest.[149] This failure to check the box freed the court from having to decide whether the seller's security interest in the first purchased

144. Billings v. Avco Colo. Indus. Bank (*In re* Billings), 838 F.2d 405, 410 (10th Cir. 1988); *In re* Short, 170 B.R. 128, 134 (Bankr. S.D. Ill. 1994); Russell v. Associates Fin. Servs. Co. of Okla., Inc. (*In re* Russell), 29 B.R. 270, 273-74 (Bankr. W.D. Okla. 1983); *In re* Gibson, 16 B.R. 257, 266 (Bankr. D. Kan. 1981).

145. Billings v. Avco Colo. Indus. Bank (*In re* Billings), 838 F.2d 405, 410 (10th Cir. 1988) (quoting H.R. REP. NO. 95-595, *reprinted in* 1978 U.S.C.C.A.N. 5787, 6088); *In re* Short, 170 B.R. 128, 134 (Bankr. S.D. Ill. 1994) (same); Russell v. Associates Fin. Servs. Co. of Okla., Inc. (*In re* Russell), 29 B.R. 270, 273-74 (Bankr. W.D. Okla. 1983) (same); *In re* Gibson, 16 B.R. 257, 266 (Bankr. D. Kan. 1981) (same).

146. *Billings*, 838 F.2d at 410.

147. *Short*, 170 B.R. at 134.

148. 84 B.R. 6, 8 (Bankr. D.R.I. 1988).

149. *Id*.

property retained its purchase-money character.[150]

When the Rhode Island bankruptcy court addressed another §522(f) question four years later, the court again made its decision based on the intent of the parties. The transaction at issue in *In re Adoptante*[151] was a refinancing. The loan documents for the refinanced loan contained a space for a security agreement and that portion of the agreement was not completed.[152] As a result, the court again refused to choose between the dual-status and transformation rules.[153] The court appeared to rely on freedom of contract in the face of a Code provision that expressly denies the parties' freedom to contract.[154]

IV. THE IRRELEVANCE OF PURCHASE-MONEY STATUS OUTSIDE OF BANKRUPTCY

One reason that federal law should define "purchase-money security interest" for consumer bankruptcy purposes is that purchase-money status is irrelevant under state law when the collateral consists of low-value consumer goods. An often cited justification for the rule that property rights are determined by state law is that the uniform treatment of property interests by all courts, state and federal, within a state is necessary to "reduce uncertainty, . . . discourage forum shopping, and . . . prevent a party from receiving 'a windfall merely by reason of the happenstance of bankruptcy.'"[155] At least one court used that reasoning to apply the dual-status rule in a lien avoidance case, stating that application of the transformation rule would potentially establish "two different systems of priorities, one in bankruptcy and the other in nonbankruptcy cases."[156] However, when the collateral consists of the type of consumer goods covered by §522(f), the characterization of a security interest as purchase-money is irrelevant outside of bankruptcy. On the other hand, in a consumer bankruptcy case, the difference between being a purchase-money secured creditor and a nonpurchase-money secured creditor is the difference between being secured and unsecured. As a result, there is no reason for federal law to defer to state law on this issue.

---

150. *Id*.
151. 140 B.R. 940, 940 (Bankr. D.R.I. 1992).
152. *Id*. at 941.
153. *Id*. at 942.
154. *Id*.
155. Butner v. United States, 440 U.S. 48, 55 (1979) (quoting Lewis v. Manufacturers Nat'l Bank, 364 U.S. 603, 609 (1960)); THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 21-22 (1986) [hereinafter JACKSON, LOGIC AND LIMITS].
156. *In re* Gibson, 16 B.R. 257, 266 (Bankr. D. Kan. 1981).

Every security interest entitles its holder to priority rights and remedy rights. The purchase-money secured party has an exalted status under Article 9 of the U.C.C. Article 9 has several provisions granting the purchase-money secured party this exalted status, and these provisions all relate to the priority aspect of the lien. The priority aspect of the lien is irrelevant outside of bankruptcy when the collateral consists of consumer goods[157] mainly because of the restrictions on, and practical realities of, consumer lending. On the other hand, every secured creditor, whether purchase-money or not, is entitled to the same remedies. Those rights include the right of self-help repossession[158] and that of foreclosure without judicial involvement.[159]

In order for a secured creditor to have priority over other creditors, a secured party must perfect its security interest. The most important perfection provision for purchase-money secured parties in consumer transactions is the provision allowing automatic perfection of purchase-money security interests in consumer goods. The U.C.C. provides that such security interests are perfected, and thus effective against the entire world, at the moment of attachment.[160] When a security interest attaches, it is effective between the debtor and the secured party. Most other secured creditors have to take the additional step of giving notice to the world of the security interest—by

157. Goods are "consumer goods" if they are "used or bought for use primarily for personal, family, or household purposes." U.C.C. § 9-102(23); Former U.C.C. § 9-109(1).

158. U.C.C. § 9-609(a) (2000); Former U.C.C. § 9-503.

159. U.C.C. § 9-610 (2000); Former U.C.C. §9-504. Once a debtor seeks protection under the Bankruptcy Code, the automatic stay prohibits the secured creditor from exercising those remedies absent an order for relief from the court. 11 U.S.C. § 362 (1994).

A creditor's purchase-money status is one of the remedy provisions of Article 9. Article 9 limits the ability of a secured creditor to retain consumer goods in satisfaction of its debt. If the debtor has paid sixty percent of the purchase price of the collateral (if the consumer goods secure a purchase-money security interest) or sixty percent of the loan (if the consumer goods secure any other debt), then, after default, the secured party cannot retain the goods in lieu of foreclosure. U.C.C. § 9-620(e); Former U.C.C. § 9-505. The purpose of the rule is to protect consumers who have a substantial equity in the collateral securing their debts, and although the calculation of the amount paid is slightly different, the same rule applies regardless of the security interest in purchase-money.

160. U.C.C. §9-309(1) (2000); Former U.C.C. §9-302(d). More accurately, an automatically perfected security interest in consumer goods is effective against almost the entire world. A consumer can sell a consumer good to another consumer and that consumer buyer will take free of an existing security interest of which he has no knowledge unless the secured party has filed a financing statement. U.C.C. § 9-320 (2000); Former U.C.C. § 9-307(2).

Under Former Article 9, several states adopted non-uniform provisions imposing a cap on the purchase price of a consumer good in which a purchase-money security interest could be automatically perfected. *See, e.g.*, KAN. STAT ANN. § 84-9-302 (1996) (providing that, in Kansas, a purchase-money security interest in a consumer good with a purchase price of $3,000 or less is automatically perfected); ME. REV. STAT. ANN. tit. 11, § 9-302 (West 1995) (stating that in Maine, the purchase price of a consumer good must be less than $2,000 for automatic perfection provisions to apply); MD. CODE ANN., COM. LAW § 9-302 (1997) (repealed 2001) (providing that purchase price of a consumer good must be $3,000 or less for automatic perfection to apply).

either filing a financing statement or taking possession or control of the collateral—in order to be perfected.[161]

The other perfection provisions are relevant only when the collateral does not consist of consumer goods. A purchase-money secured party has priority over a lien creditor who gains rights in the collateral between attachment and filing if the secured party files its financing statement within 20 days after the debtor receives delivery of the collateral.[162] When the goods are consumer goods, this provision is irrelevant because, as explained above, the secured creditor's interest is automatically perfected upon attachment.

The twenty day grace period also appears in Article 9's major priority section. If a secured party perfects its interest in collateral other than inventory within twenty days after the debtor receives possession of the collateral, that secured party has priority over all conflicting security interests in the collateral, regardless of when they arose.[163] When the collateral is inventory subject to a floating lien, the purchase-money secured party is entitled to priority over the floating lienor, so long as the purchase-money secured party complies with the notification requirements set forth in Article 9.[164]

When the secured party's collateral consists of property other than consumer goods, the priority provisions are of great importance. A creditor with a floating lien on all of the equipment in a factory will lose to a supplier who sells a piece of equipment on credit if that supplier perfects its security interest in the equipment within twenty days.[165] A creditor who has a floating lien on all of a store's inventory also loses out. A supplier who takes a security interest in the inventory sold takes priority if it complies with certain notification requirements.[166]

The irrelevance of purchase-money status outside of bankruptcy stems from the fact that when consumer goods are collateral, no competing secured party will exist. The term "consumer goods" in Article 9 is defined broadly; it is possible that a yacht can be classified as a consumer good.[167] Expensive consumer goods can of course be used as collateral twice; however, the

161. U.C.C. § 9-309 (2000); Former U.C.C. § 9-302.

162. U.C.C. §9-317(e) (2000); Former U.C.C. §9-301. Former Article 9 provided for a ten-day grace period.

163. U.C.C. § 9-324(a) (2000); Former U.C.C. § 9-312(4) (providing for ten-day grace period).

164. U.C.C. § 9-324(b) (2000); Former U.C.C. § 9-312(3).

165. For an excellent discussion of the importance of purchase-money status in the business context, see Gerald T. McLaughlin, *"Add On" Clauses in Purchase Money Financing: Too Much of a Good Thing*, 49 FORDHAM L. REV. 661 (1981).

166. UCC § 9-324(b) (2000); Former UCC § 9-312(3).

167. Gallatin Nat'l Bank v. Lockovich (*In re* Lockovich), 124 B.R. 660, 662 (W.D. Pa.), *aff'd* 940 F.2d 916 (3d Cir. 1991).

priority of the various secured creditors will not depend on the purchase-money status of one or the other. Purchase-money status is important when the competing creditor holds a floating lien, and the U.C.C. does not allow after-acquired property clauses to extend to consumer goods, unless the goods are acquired within 10 days after the secured party gives value.[168] Because the goods would then be purchase-money collateral, there would not be a competing creditor who extended purchase-money financing for the after-acquired property. The irrelevance of purchase-money status outside of bankruptcy is also evident when the competing creditor is a lien creditor. Because purchase-money security interests in consumer goods are perfected automatically, the twenty-day grace period is unnecessary, as there will not be an intervening lien creditor.

Federal law also renders purchase-money status irrelevant outside of bankruptcy. Under a rule promulgated by the Federal Trade Commission, it is an unfair credit practice for a creditor to take a non-possessory security interest in certain household goods unless the security interest is a purchase-money security interest.[169] The FTC rule does not define purchase-money security interest, but it does not need to because it focuses on the taking of a security interest.[170] Each time a creditor advances money to a debtor to buy goods and takes a security interest to secure the purchase price, it creates a purchase-money security interest in those goods. The definitional problem arises when goods are bought on an account and earlier purchased goods remain as collateral for the purchase price of the later purchased goods. The FTC rule does not address that situation.

In a consumer bankruptcy case, however, purchase-money status takes on great importance. A creditor's status as a purchase-money secured creditor is highly relevant inside of bankruptcy due to the debtor's right to avoid non-possessory, non-purchase-money security interests in certain consumer goods under § 522(f). The debtor can avoid such an interest to the extent that it impairs an exemption to which the debtor is otherwise entitled if the security interest is in "household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, or jewelry" that are held primarily for the debtor's personal, family, or household use.[171] The effect of avoidance is to allow the debtor to keep the property. If the security interest is a purchase-money security interest, however, it is unavoidable and

168. U.C.C. § 9-204 (2000); Former U.C.C. § 9-204.

169. FTC Credit Practices Rule, 16 C.F.R. § 444.2 (1999).

170. *Id*.

171. 11 U.S.C. § 522(f)(1)(B)(i) (1994). The debtor has the same right with respect to tools of the trade and professionally prescribed health aids.

the secured creditor has the right to the value of the collateral.

Even if the collateral is not within § 522(f), the designation of purchase-money status is critical. Due to the interplay between the Bankruptcy Code and the U.C.C., the determination of whether a secured party is a purchase-money secured party is integral to the issue of whether the secured party has any security interest enforceable against the trustee in bankruptcy. Because a creditor with a purchase-money security interest in consumer goods need not file a financing statement to perfect its security interest,[172] a finding of non-purchase-money status will render the non-filing creditor unperfected. If that creditor is unperfected and the debtor files for bankruptcy, the trustee in bankruptcy can use the strong-arm powers to set aside the security interest,[173] leaving the formerly secured creditor in the position of a general unsecured creditor in the debtor's bankruptcy. As an unsecured creditor, the creditor will receive less of a distribution from the estate,[174] will not be able to take advantage of relief from the automatic stay,[175] and will have a more difficult time obtaining a reaffirmation of its debt.[176]

In bankruptcy, a secured creditor is entitled to the lesser of the amount it is owed or the value of the collateral.[177] An unsecured creditor, on the other hand, is entitled to its pro-rata share of what is left in the estate after all secured and priority claims are paid in full.[178] This holds true in Chapter 13 cases as well as Chapter 7 cases. While an unsecured creditor in a Chapter 7 receives its portion of what remains after all non-exempt property is sold, an unsecured creditor in a Chapter 13 case must receive at least what it would receive in a Chapter 7 case. Unless the trustee or a creditor objects to the plan, the unsecured creditor need not receive any more than it would receive in a Chapter 7 case.[179]

A secured creditor in bankruptcy also has tremendous leverage over a debtor because it can move for relief from the automatic stay. Without relief from the stay, even secured creditors must generally wait until the case is

172. U.C.C. § 9-309(1) (2000), Former U.C.C. § 9-302(1)(d).
173. 11 U.S.C. § 544 (1994).
174. *Id*. §§ 726, 1325(a)(4).
175. *Id*. § 362.
176. *Id*. §524. The National Bankruptcy Review Commission (NBRC), in its 1997 report, recommended that the Code require holders of security interests in household goods to petition the court for recognition of their security interests. The NBRC recommended that courts not recognize such security interests if the value of the collateral is less than $500. In advocating such an approach, the Report states that "[t]he ability to reaffirm secured debts . . . makes it especially important to be clear about what constitutes a secured debt." 1 NAT'L BANKR. REVIEW COMM., BANKRUPTCY: THE NEXT TWENTY YEARS 169 (1997) [hereinafter NBRC REPORT].
177. 11 U.S.C. § 506(a) (1994).
178. *Id*. §§ 726, 1325(a)(4).
179. *Id*. § 1325(b).

closed to exercise their rights against the collateral.[180] If secured, the creditor can obtain relief from the stay, either because its interest in the collateral is not adequately protected or because the debtor has no equity in the property and does not need the property for his reorganization.[181] The threat of repossession, either after a successful relief from stay motion or after the case is closed, is often enough to cause a debtor to reaffirm its debt to the secured creditor.[182] On the other hand, the unsecured creditor possesses no such leverage, as the debtor often has no incentive to reaffirm an unsecured debt. Therefore, the holder of a purchase-money security interest in consumer goods will argue vigorously that purchase-money status survives refinancing and additional collateral.

V. THE LIMITS OF CONGRESSIONAL POWER UNDER THE BANKRUPTCY CLAUSE

Congress has the power to define property rights in bankruptcy. The Bankruptcy Clause of the Constitution gives Congress the power to make "uniform laws on the subject of Bankruptcies."[183] Since the Code was first enacted in 1978, Congress has amended the Code several times to codify the decisions of federal courts, affecting property rights.

Clearly, Congress has the right to alter entitlements in bankruptcy, as it has in the areas of the automatic stay and the trustee's avoiding powers.[184] The automatic stay does not invalidate liens, but it does bar creditors from pursuing the remedies that arise from those liens, absent relief from the stay.[185] The trustee in bankruptcy has the power to avoid preferential transfers, which can include security interests that would be valid outside of bankruptcy.[186] Through the strong-arm power, a trustee can avoid unperfected security interests, which again would be valid but for the debtor's bankruptcy filing.[187]

Early bankruptcy history gives little guidance as to the limits of the bankruptcy clause.[188] Throughout history, courts have agreed that the clause is malleable and that it should adapt to changing conditions. The courts have

180. *Id*. § 362(c).
181. *Id*. § 362(d).
182. *Id*. § 524(c).
183. U.S. CONST. art. I, § 8, cl. 4.
184. *See Raleigh v. Ill. Dep't of Revenue*, 530 U.S. 15, 21 (2000).
185. 11 U.S.C. § 362 (1994).
186. *Id*. § 547(b).
187. *Id*. § 544.
188. CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 7 (1935), Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 TENN. L. REV. 487, 528 (1996).

not shed much light, however, on the circumstances in which state law must yield to bankruptcy principles.[189] Many courts have held that the Bankruptcy Clause requires the suspension of state laws only to the extent that those laws conflict with the bankruptcy system.[190] It may be difficult to determine, however, when state laws are in actual conflict with the bankruptcy system. In 1935, the Supreme Court suggested that the best way to fix the nature of Congress' power under the bankruptcy clause was "historical and judicial inclusion and exclusion."[191] Certainly, past practice indicates that Congress possesses the power to define the term "purchase-money security interest."

A. Three Views on the Scope of the Bankruptcy Clause

Contemporary scholars have expressed differing opinions on the scope of the Bankruptcy Clause. Using the broadest reading of the Bankruptcy Clause, Professor David Phillips recommends the federal codification of all personal property security laws, now codified in the various state enactments of Article 9 of the Uniform Commercial Code.[192] Noting that the historical reasons for the presumption that the Tenth Amendment limited Congress' ability to regulate commerce under the Commerce Clause have largely disappeared, he suggests that Congress has the power, under the Bankruptcy Clause itself, to pass a law governing security interests.[193] Although the federal character of bankruptcy law is only one of the reasons given by Professor Phillips for federalizing secured transactions law,[194] he recommends that the law of secured transactions be integrated into the Bankruptcy Code.[195]

Under a more narrow reading, Congress has the power to enact legislation dealing with the problems faced by insolvent debtors. Under Professor James Rogers' reading of the Bankruptcy Clause, Congress has the power to deal

189. Alfred Hill, *The Erie Doctrine in Bankruptcy*, 66 HARV. L. REV. 1013, 1036 (1953).

190. *See, e.g.*, Stellwagen v. Clum, 245 U.S. 605, 613 (1918).

191. Cont'l Ill. Nat'l Bank & Trust Co. v. Chi., Rock Island & Pac. Ry. Co., 294 U.S. 648, 670 (1935).

192. David M. Phillips, *Secured Credit and Bankruptcy: A Call for the Federalization of Personal Property Security Law*, 50:2 LAW & CONTEMP. PROBS. 53, 57 (1987).

193. *Id.* at 57. The author cites, as an example, federal regulation of mining, which affects rights to real property (traditionally seen as exclusively within the purview of state law). *Id.* The federal government has already legislated in the payments area, with the Expedited Funds Availability Act, 12 U.S.C. §§ 4001-10 (1994), and the Electronic Funds Transfer Act, 15 U.S.C. §§ 1693-93r (1994), standing as two examples of federal commercial law legislation.

194. The other reasons include the lack of uniformity in secured transactions law, needless transaction costs as a result of such nonuniformity, and the fact that federal courts are the primary arbiters of secured transactions problems. Phillips, *supra* note 192, at 75-76.

195. *Id.* at 54.

with those problems by altering the contractual and property rights of debtors, creditors, and investors.[196] In Professors Rogers' opinion, the Bankruptcy Clause itself is the only substantive limitation on Congress' bankruptcy power, not the Fifth Amendment or any other part of the Constitution.[197]

Rogers' thesis posits that the only constitutional limitation on bankruptcy legislation is the limitation provided by the Bankruptcy Clause itself.[198] Reviewing some of the early cases, he argues that the bankruptcy power permits Congress to enact a law governing contractual relations.[199] As examples, he cites the exemption provisions and the discharge provisions as constitutionally justifiable.[200] The enactment of provisions allowing exemptions and discharge are permissible because they further the "fresh start" policy of the Code.[201] Although the article focuses on reorganizations, Rogers cites the following two primary justifications for bankruptcy legislation: the fresh start for individual debtors and the preservation of an enterprise's earning power for the benefit of all affected for business debtors.[202]

Under a third view, the power to adopt uniform laws on the subject of bankruptcies is limited to the power to adopt laws on the subject of the relationship between insolvent debtors and their creditors.[203] As a result, Congress should not enact laws in reliance on the bankruptcy power, which generally adjust debtor-creditor relations. Permissible legislation under this view includes legislation that would result in a benefit to a debtor at the expense of his creditors. Adhering to this view of the limitations of the bankruptcy clause, Professor Thomas Plank points to several places in the Bankruptcy Code in which Congress has arguably exceeded its power under

---

196. James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973, 973 (1983).

197. *Id*. at 986-87.

198. *Id*. at 998.

199. *Id*. at 1001.

200. *Id*.

201. *Id*.

202. *Id*. at 1004-05.

203. *See generally* Wright v. Union Cent. Life Ins. Co., 304 U.S. 502, 513-14 (1938); Hanover Nat'l Bank v. Moyses, 186 U.S. 181 (1902); Plank, *supra* note 188. Professor Plank advocates insolvency as a requirement for a bankruptcy filing so that solvent debtors are precluded from using bankruptcy strategically. Plank, *supra* note 188, at 548. Most debtors, particularly consumer debtors, are insolvent. A recent study of consumer debtors in sixteen districts showed that the mean net worth of debtors in bankruptcy was -$16,819 and the median net worth was -$10,542. TERESA A. SULLIVAN ET AL., THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT 72 (2000). *See also* NBRC REPORT, *supra* note 176, at 82-86 (detailing some of the reasons for the rise in consumer bankruptcies).

the Bankruptcy Clause by providing benefits or imposing burdens on third parties directly and not as by-products of debtor or creditor benefits.[204] Congressional definition of "purchase-money security interest" falls well within this view of Congressional power under the Bankruptcy Clause because such a definition determines whether the secured creditor or the debtor is entitled to the collateral in bankruptcy. Either way, the property would not be available for distribution to creditors, therefore, third-party rights are in no way implicated.

B. Congress' Gap Filling Role Under the Bankruptcy Clause

The *Stellwagen*[205] decision suggests another, perhaps complementary approach to the power of Congress to affect a debtor's state created property rights. Congress should consider the goals of the bankruptcy system and how the various Code sections effectuate such goals. If the existing legislation inadequately effectuates such goals, then Congress should fill the gap in the legislation. Congress has already done so in the 1994 Amendments.[206] The gap filling powers of Congress have been noted before,[207] and even alluded to in the *Butner* case.[208] The Supreme Court has placed limits on the gap filling power,[209] but as will be illustrated in the next section, it is appropriate for Congress to exercise such powers to define the extent of a purchase-money security interest.

The problem caused by different definitions of "purchase-money security interest" is amenable to Congressional gap filling because of the complete lack of guidance currently given in the Code. Congress has already modified state created property rights by enacting § 522 invalidating otherwise valid security interests.[210] The debtor's ability to avoid non-purchase-money, non-possessory security interests under § 522 does not expressly incorporate a state law definition of purchase-money security interests.[211] This lack of a

---

204. One example is the use of § 105 of the Code to extend the benefits of the automatic stay to officers, directors, or shareholders of corporate debtors. Plank, *supra* note 188, at 570.

205. Stellwagen v. Clum, 245 U.S. 605 (1918).

206. *See* Ponoroff, *supra* note 17, at 28.

207. Robert J. Keatch, *The Continued Unsettled State of Constructive Trusts in Bankruptcy: Of Butner, Federal Interests and the Need for Uniformity*, 103 COM. L.J. 411, 443 (1998).

208. Butner v. United States, 440 U.S. 48, 54 (1979).

209. O'Melveny & Myers v. FDIC, 512 U.S. 79, 88 (1994) (stating that federal rules of decision should not be applied solely in interest of uniformity).

210. 11 U.S.C. § 522 (1994).

211. *Id*.

eference to state law makes § 522(f) different from the sections of the Code giving the trustee power to avoid certain property interests in bankruptcy.[212]

The trustee's strong-arm power is expressly subject to state law because a trustee has the rights of a creditor with a judicial lien or of a bona fide purchaser of real property. If the trustee has the rights of a bona fide purchaser of real property, the Code directs the trustee to look to "applicable law" to determine the rights of the bona fide purchaser.[213] The trustee's avoiding powers are limited by state law in § 546 of the Code, which makes the trustee's rights subject to a statutory or common law right of a seller of goods to reclaim those goods.[214] Although the priority of the seller's right to reclaim goods when a buyer files for bankruptcy has been the subject of some litigation, courts agree that because the right to reclaim exists only in state law, state law governs the priority between a reclaiming seller and a secured party in bankruptcy.[215] The power to set aside fraudulent transfers under § 546(b) of the Code is also made expressly subject to state law, again, because the power to avoid fraudulent transfers exists under both state law and in bankruptcy.[216]

Congress has exercised its power within this framework to define property rights in the Code. Notably, the Bankruptcy Code defines the term "transfer" for the purpose of the preference avoidance power.[217] Unlike the avoiding powers enumerated above, the trustee's power to avoid preferential transfers is unique to bankruptcy and does not mirror any state-law right. Under the Bankruptcy Code, the trustee in bankruptcy can avoid certain transfers of an insolvent debtor's property if such transfer occurred within ninety days of the bankruptcy filing, was offered in exchange for an antecedent debt, and enabled the creditor to receive more than it would in a Chapter 7 case.[218] The power to avoid preferential transfers evinces a bankruptcy policy against allowing debtors to prefer one creditor over another on the eve of bankruptcy, as well as a policy against allowing creditors to improve their positions with respect to debtors' property

212. At least one bankruptcy judge attributes the split in the cases on the issue of purchase-money security interests in consumer goods to the absence of clear direction in the Bankruptcy Code. *See* Hon. Nancy C. Dreher, *One Judge's View of the Uniform Commercial Code in Bankruptcy Court: Why It Doesn't Work the Way You Thought It Would*, 79 MINN. L. REV. 777, 784 (1995).

213. 11 U.S.C. § 544(a)(3) (1994).

214. *Id*. § 546(c).

215. *In re* Reliable Drug Stores, Inc., 70 F.3d 948, 949 (7th Cir. 1995); Isaly Klondike Co. v. Sunstate Dairy & Food Prods. Co. (*In re* Sunstate Dairy & Food Prods. Co.), 145 B.R. 341, 344 (Bankr. M.D. Fla. 1992); *In re* Shattuc Cable Corp., 138 B.R. 557, 564 (Bankr. N.D. Ill. 1992).

216. 11 U.S.C. § 546(b).

217. 11 U.S.C. § 547.

218. *Id*.

immediately before a bankruptcy filing. Under the state law of secured transactions as set forth in the U.C.C., a security interest is transferred to the secured party when the debtor enters into an agreement with the secured party granting that interest, the secured party gives value, and the debtor has rights in the collateral.[219] At that point, the moment of attachment, the lender is secured and therefore has the bundle of remedies to which a secured party is entitled, such as the right of self-help repossession.[220] In some cases, however, the Bankruptcy Code dictates that the transfer takes place not when the security interest is granted, but when it is perfected, if that perfection takes place more than 10 days after the security interest attaches.[221] Therefore, while state law defines the property right resulting from the transfer, federal law defines when the transfer takes place because the preference avoidance power is one without counterpart in state law. As a result of the federal definition, trustees can occasionally avoid otherwise valid security interests.

Congress was within its rights to define transfer for the purpose of voidable preferences, because the idea behind voidable preferences is to deter creditors from improving their positions on the eve of bankruptcy. Since an unperfected secured creditor loses to the trustee in bankruptcy, the move to perfect an unperfected security interest results in an improvement of position. Because the power to avoid preferential transfers is a power intended to be exercised in a uniform manner throughout the country, the definition of the important terms relating to the exercise of the power is a federal question.[222]

C. Filling the Gaps Since 1978

Since the Code was enacted in 1978, Congress has used its gap filling power several times to clarify language in the Code. Congress has made several revisions to the Code since 1978, two of which are significant for their usurpation of the states' role in defining property rights in bankruptcy. Both of the revisions were made in the 1994 Amendments to the Code and were made in response to divergent judicial views about the relationship between state and federal law in bankruptcy.[223] One amendment revised § 522(f) to clarify, for the purpose of the debtor's ability to avoid liens, the extent to which a lien impairs an exemption to which a debtor is otherwise

219. U.C.C. § 9-203, Former U.C.C. § 9-203.
220. U.C.C. § 9-203(b) (2000); Former U.C.C. § 9-203(1).
221. 11 U.S.C. § 547 (e)(2)(C) (1994).
222. Countryman II, *supra* note 7, at 632.
223. *See* Ponoroff, *supra* note 17, at 27.

entitled.[224] Another revised §1322(c) to clarify the point at which the debtor's right to cure a mortgage default expires.

1. Clarifying § 522(f)

In the cases that spurred the amendments to § 522, litigants asked courts to determine the extent of the opt-out.[225] The exemption provisions in the Code exemplify the state law-federal law tension in the Code. The Code allows states to reject the scheme of exemptions provided in the Bankruptcy Code; in those states, a debtor in bankruptcy can take advantage of only his state's exemption laws. On the other hand, a debtor in a state that has not opted out has the choice of either her state's exemptions or the Bankruptcy Code's exemptions.[226] The issue in the cases was whether the opt-out applied only to the Code's list of exemptions in § 522(d) or to § 522 in its entirety, including the debtor's power to avoid liens. These cases are illustrative in that they provide discussions of the purpose of the debtor's lien avoidance powers and the purpose of the opt-out.

The circuits addressing the extent of the opt-out were split between those holding that state law determines the extent of a debtor's interest in property[227] and those holding that federal law determines the extent of a debtor's interest in property.[228] In those cases, state exemption statutes used terms such as the "debtor's interest"[229] and "debtor's equity"[230] in their definitions of exempt property. In bankruptcy, the debtors attempted to avoid liens using § 522(f), and in each case the secured creditor claimed that its lien did not impair an exemption to which the debtor was otherwise entitled because under the relevant state exemption laws, if the debtor had no "equity" or "interest" in the property at the time of her bankruptcy filing, the

224. *Id*. at 28.

225. 11 U.S.C. §522(b) allows states to opt out of the Bankruptcy Code's exemptions. Thirty four states have opted out, and, in those states debtors in bankruptcy are entitled only to the exemptions granted by state law and federal law other than bankruptcy law. 4 COLLIER ON BANKRUPTCY ¶ 522.02[1] (Lawrence P. King ed., 15th ed. rev. 1996).

226. The opt-out was the result of a last minute compromise prior to the passage of the 1978 Code. For a good discussion of the compromise, see William J. Woodward, Jr., *Exemptions, Opting Out, and Bankruptcy Reform*, 43 OHIO ST. L.J. 335 (1982).

227. Allen v. Hale County State Bank (*In re* Allen), 725 F.2d 290, 292 (5th Cir. 1984); Pine v. Credithrift of Am., Inc. (*In re* Pine), 717 F.2d 281 (6th Cir. 1983); McManus v. Avco Fin. Servs. of La. (Matter of McManus), 681 F.2d 353, 357 (5th Cir. 1982).

228. Hall v. Fin. One of Ga. (*In re* Hall), 752 F.2d 582 (11th Cir. 1985); Maddox v. S. Disc. Co. (*In re* Maddox), 713 F.2d 1526, 1527 (11th Cir. 1983).

229. *See, e.g*., *Hall*, 752 F.2d at 585 (citing GA. CODE ANN. § 44-13-100(a)(4) (1982)).

230. *See, e.g*., *Maddox*, 713 F.2d at 1529.

debtor had no property in which to claim an exemption.[231]

Section 522(f) allows a debtor to avoid a lien only to the extent that it impairs an exemption to which the debtor is otherwise entitled.[232] The Fifth and Sixth Circuits stressed the plain language of § 522(f) in holding that a state could, by opting out of the Code's exemption scheme, effectively prevent its debtors from using § 522(f) to avoid liens.[233] The court in *Pine v. Credithrift of America* (*In re Pine*)[234] found in Congress' adoption of the opt out a preference for state control of exemptions.[235] The relevant exemption statutes, those of Georgia and Tennessee, exempted the "debtor's interest" in property and the "debtor's equity interest," respectively.[236] As a result, the court held that the debtors could not use § 522(f) to avoid liens because under the state exemption laws, property encumbered by liens was not exempt property.[237] The court relied on the Fifth Circuit's decision in *McManus v. Avco Financial Services of Louisiana, Inc.* (*In re McManus*),[238] which stressed that § 522(f) provided only a limited mechanism for avoiding liens, not a separate exemption statute.[239] As a result, the debtor in *McManus* was entitled only to avoid liens on property otherwise exempt under § 522(b), which incorporates the opt-out and thus defers to the applicable state definition of exempt property.[240]

In rejecting the Fifth and Sixth Circuits' reasoning and upholding the debtor's right to avoid a lien pursuant to § 522(f) in property arguably not exempt under Georgia law, the Eleventh Circuit in *Hall v. Finance One of Georgia* (*In re Hall*)[241] pointed to the Supremacy Clause of the United States Constitution as well as the purpose behind § 522(f).[242] The court noted that, due to the opt-out provision, states are empowered to decide what types of property are exempt as well as to decide that encumbered property is not exempt.[243] However, because the Code explicitly allows debtors to claim as exempt property subject to a lien, the Supremacy Clause dictates that state law must yield to federal law on the question of the debtor's ability to avoid a

231. *See, e.g.*, *Hall*, 752 F.2d at 584.
232. 11 U.S.C. § 522(f)(1) (1994).
233. *McManus*, 681 F.2d at 355; *Pine*, 717 F.2d at 284.
234. *Pine*, 717 F.2d at 284.
235. *Id*. at 284.
236. *Id*. at 283 (citing GA. CODE ANN. § 51-160; TENN. CODE ANN. § 26-2-112).
237. 717 F.2d 281, 284 (6th Cir. 1983).
238. 681 F.2d 353 (5th Cir. 1982).
239. *Pine*, 717 F.2d at 284 (citing *McManus*, 681 F.2d at 357).
240. *McManus*, 681 F.2d at 355-56.
241. 752 F.2d 582 (11th Cir. 1985).
242. *Id*. at 586-87.
243. *Id*. at 586.

lien under § 522(f).[244] In addition, because the purpose behind the enactment of § 522(f) was to discourage unconscionable creditor practices, the court held that the applicability of that provision must extend to state law exemptions.[245] Thus, the court looked to the purpose of the lien avoidance provisions in ruling that they superceded seemingly contrary state law.

The Supreme Court in *Owen v. Owen*[246] implied that the content of state exemption law could be ignored in applying § 522(f). Although Justice Scalia relied primarily on a plain reading of the Bankruptcy Code to arrive at a decision, the relationship between state and federal law in using § 522 to avoid liens played a role in the Court's decision.[247] In *Owen*, the creditor was the debtor's ex-wife.[248] She had obtained a judgment against her ex-husband and, as a result, obtained a lien against his after-acquired property.[249] Sometime after she obtained the lien, he bought a condominium; at the time of the purchase, the condominium did not qualify as a homestead.[250] Although Florida later changed its laws to provide that such property qualified as homestead property, the Florida law was inapplicable to pre-existing liens.[251] The debtor sought to avoid this lien pursuant to § 522(f)(1), which allows a debtor to avoid a judicial lien on exempt property.[252] His ex-wife challenged his use of the lien avoidance provision, arguing that because the homestead exemption could not be asserted against pre-existing judicial liens, the debtor was not entitled to an exemption.[253]

The Court, noting several decisions that deferred to state definition of the extent of the exemption, rejected this argument.[254] In part, the Court rejected the argument because even the federal exemptions in the Code are limited to the "debtor's interest" in certain types of property; the debtor's interest is often merely the legal interest because a creditor with a lien entirely encumbering the property would have the equitable interest.[255] In addition, the Code, which at the time did not define the impairment of an exemption, allowed the debtor to avoid a lien on property, which impaired an exemption

244. *Id*. at 586-87.
245. *Id*. at 588.
246. 500 U.S. 305, 313-14 (1991).
247. *Id*.
248. *Id*. at 306.
249. *Id*. at 306-07.
250. *Id*. at 307.
251. *Id*.
252. *Id*.
253. *Id*. at 309.
254. *Id*. at 310-11.
255. *Id*. at 311-13.

to which the debtor would have been entitled.[256]

The Court made a policy statement about the relationship between state and federal law in bankruptcy as well. The Court noted that the lower courts unanimously applied § 522(f) to the federal exemptions, even though those exemptions are also limited by phrases such as "the debtor's aggregate interest."[257] In those cases, the courts first asked whether avoiding the lien would entitle the debtor to an exemption.[258] If the answer to the first question was yes, then the debtor could avoid the lien.[259] The Court then inquired whether a different rule should apply to property that the debtor seeks to exempt under state-law exemptions.[260] It found that Congress had no such intention in enacting § 522(f).[261]

The Court rejected the creditor's argument that the Court's position was inconsistent with the opt-out.[262] It reasoned that it was not inconsistent with the policy of having state-defined exemptions to have a policy against certain types of liens upon those exemptions, whether created by state or federal law.[263]

After the *Owen* case, Congress refined § 522(f). Prior to the 1994 Amendments, the Code did not define "impairment" for purposes of determining whether a lien could be set aside under § 522(f). In the current version of § 522(f), impairment is defined by a clear mathematical formula.[264] This amendment codified *Owen* to the extent that the Court in *Owen* held that states cannot opt out of § 522(f) by cleverly wording their exemption statutes.[265]

2. Defining the Parameters of the Right to Cure a Home Mortgage

Parties litigated the question of how late in the foreclosure process a debtor can cure a home mortgage default many times before the 1994 Amendments to the Code. As a result of the 1994 Amendments, a debtor can now cure a mortgage default and reinstate the mortgage debt at any time until

256. *Id*. at 311.
257. *Id*. at 312.
258. *Id*. at 312-13.
259. *Id*.
260. *Id*. at 313.
261. *Id*.
262. *Id*.
263. *Id*.
264. 11 U.S.C. §522(f) (1994). *See also* Margaret Howard, *Avoiding Powers and the 1994 Amendments to the Bankruptcy Code*, 69 AM. BANKR. L.J. 259, 268-77 (1995); Ponoroff, *supra* note 17, at 27-34 (1999).
265. David Gray Carlson, *Security Interests on Exempt Property After the 1994 Amendments to the Bankruptcy Code*, 4 AM. BANKR. INST. L. REV. 57, 63-64 (1996).

the property is sold at a foreclosure sale, regardless of any state-law pronouncement as to when the debtor's property rights are terminated.[266] Before Congress amended the Code, however, courts around the country disagreed as to when the debtor's right to cure was extinguished.[267] Specifically, courts disagreed on the meaning of the word "cure."

The pre-1994 home mortgage cases provide a useful analogy to the current purchase-money security interest cases. Before the 1994 Amendments, § 1322 was written broadly and allowed a Chapter 13 debtor to provide in his plan for the cure of any default on long-term debt and maintenance of payments on that debt.[268] This section qualified (and still qualifies) another subsection, which prohibits a Chapter 13 debtor from modifying the rights of the holder of a home mortgage.[269] Because the Bankruptcy Code failed to state when a mortgage loan was beyond cure, courts were forced to find a date themselves. While some courts adhered to state law in finding the date,[270] others fashioned a federal rule based on the rehabilitative purpose of Chapter 13.[271] From the resulting mélange of opinions, the following four rules emerged: (1) the debtor could cure a mortgage default until the date of acceleration; (2) the debtor could cure a mortgage default after acceleration but before a foreclosure judgment; (3) the debtor could cure a mortgage default after a foreclosure judgment but before a sale; and (4) the debtor could cure a mortgage default after a sale but before the expiration of a statutory redemption period.[272]

The Sixth Circuit's opinion in *Federal Land Bank of Louisville v. Glenn* (*In re Glenn*)[273] illustrates how some federal courts have fashioned a federal standard to deal with what many people would consider a question of state law. The *Glenn* court addressed three appeals, one in which the debtors had filed a Chapter 13 petition after a judgment of foreclosure but before the sale and two in which the debtors had filed their petitions after the foreclosure

266. 11 U.S.C. § 1322(c)(1) (1994). For a more detailed discussion of this issue, *see* Marianne B. Culhane, *Home Improvement? Home Mortgages and the Bankruptcy Reform Act of 1994*, 29 CREIGHTON L. REV. 467 (1996).

267. Fed. Land Bank of Louisville v. Glenn (*In re* Glenn), 760 F.2d 1428, 1432 (6th Cir.), *cert. denied*, 474 U.S. 849 (1985) (surveying different judicial approaches to the issue).

268. 11 U.S.C. § 1322 (1988).

269. *Id.*

270. *See, e.g.*, *In re Roach*, 824 F.2d 1370, 1379 (3d Cir. 1987).

271. Di Pierro v. Taddeo (*In re* Taddeo), 685 F.2d 24, 29 (2d Cir. 1982); Culhane, *supra* note 266, at 484.

272. *See Glenn*, 760 F.2d at 1432 (cataloguing the various opinions).

273. 760 F.2d 1428 (6th Cir. 1985).

ale had taken place but before the statutory redemption period had expired.[274] The court addressed two seemingly conflicting policies behind the Code's treatment of home mortgages, the desire to protect mortgagees so as not to inhibit the availability of home mortgage loans and the desire to make Chapter 13 bankruptcy an attractive alternative to debtors by allowing them to pay their debts according to a plan while keeping their assets, particularly their homes.[275] To satisfy the two competing policies, the court chose the date of the foreclosure sale as the date after which the debtor's right to cure a mortgage default was lost.[276] The court picked the date of foreclosure as the termination point in part to avoid the widely varying state laws regarding foreclosure.[277] Because all foreclosure statutes provide for a sale of which the debtor is ample notice and the sale effects a change in ownership, the court held that using the date of sale best served the policies behind the Code.[278]

The Second Circuit, in *Di Pierro v. Taddeo* (*In re Taddeo*),[279] also applied a federal definition of cure, deferring to the consumer protective policies of the Code.[280] In holding that the power to cure a default included the right to de-accelerate, the court recognized that a contrary result, which would have "remit[ted] consumer debtors . . . to the harsher mercies of state law,"[281] would be at odds with the "overriding rehabilitative purpose of Chapter 13."[282] The court also stressed the sophistication gap between mortgage creditors and consumer debtors and stated that if acceleration were permitted to cut off the debtor's right to cure, mortgagees would possess an "insurmountable advantage" in the race to the courthouse.[283]

Not all courts followed the approach of the Second and Sixth Circuits. The Third and Seventh Circuits in *In re Roach*[284] and *In re Clark*[285] adhered strictly to the state law definition of the debtor's rights after a judgment of

274. *Id*. at 1429-30.
275. *Id.* at 1434.
276. *Id*. at 1435.
277. *Id*. at 1436.
278. *Id*.
279. 685 F.2d 24 (2d Cir. 1982).
280. *Id*. at 29.
281. *Id*. at 25.
282. *Id*. at 29 (quoting *In re* Davis, 15 B.R. 22, 24 (Bankr. D. Kan.), *aff'd*, 16 B.R. 473 (D. Kan. 1981)).
283. *Id*. at 27. Although the court in *In re Roach* based its ultimate holding on state law, it agreed that terminating the right to cure at the moment of acceleration would fail to provide debtors with the relief contemplated by Congress in enacting the Code. *In re* Roach, 824 F.2d 1370, 1377 (3d Cir. 1987).
284. 824 F.2d 1370 (3d Cir. 1987).
285. 738 F.2d 869 (7th Cir. 1984).

foreclosure.[286] In *Clark* the Seventh Circuit based its decision on the fact that, under Wisconsin law, the effect of a judgment of foreclosure was simply to confirm the acceleration of the debt and not to effectively transfer title to the mortgagee.[287] As a result, the debtors in *Clark* were permitted to reinstate their mortgage after a judgment of foreclosure.[288]

The court in *Roach*, unlike the court in *Taddeo*, found no compelling reason to override state law and concluded that a reading of § 1322(b) must incorporate state law.[289] Under the applicable New Jersey law, a judgment of foreclosure terminated the contractual relationship between the mortgagor and mortgagee because the mortgage was merged into the final judgment.[290] The Third Circuit adhered to the principle that a court should not lightly infer that Congress intends to pre-empt state law.[291] Thus, the court began its analysis with the assumption that Congress did not intend to displace state law.[292]

In analyzing the issue, the court pointed to several preemption cases holding, among other things, that if there is no conflict between state and bankruptcy laws, the law of the state where the property is located governs questions of property rights.[293] Because, under New Jersey law, there was no mortgage to be cured, the court held that New Jersey debtors could not cure and reinstate their mortgage obligations after a judgment of foreclosure.[294] Relying on *Butner*, the court found no federal interest that would justify a uniform result in bankruptcy courts throughout the country.[295] The court rejected the approach taken by the Sixth Circuit in *Glenn*, which was to adopt a federal rule in part because of the hodgepodge of state foreclosure laws.[296] The *Roach* court found that consumer debtors would be adequately protected if the right to cure were terminated upon a judgment of foreclosure because such a judgment could only be entered after the debtor received adequate notice and an opportunity to answer.[297]

With the 1994 Amendments Congress ultimately recognized a federal interest in fixing a cure date at the date of the foreclosure sale; according to

286. *Roach*, 824 F.2d at 1379; *Clark*, 738 F.2d at 871.
287. *Id*. at 871.
288. *Id*. at 874.
289. *Roach*, 824 F.2d at 1379.
290. *Id.* at 1377.
291. *Id*. at 1373.
292. *Id*. at 1374.
293. *Id*. at 1373-74.
294. *Id*. at 1379.
295. *Id*.
296. *Id.* (citing In re *Glenn*, 760 F.2d 1428, 1436 (6th Cir. 1985)).
297. *Id*. at 1378.

the legislative history, decisions such as *Roach* were "in conflict with the fundamental bankruptcy principle allowing the debtor a fresh start."[298]

D. What Is a "Tax?" The Court Has Acted, Now It Is Congress' Turn

Another area in which Congress could legislate pursuant to its gap filling power under the Bankruptcy Clause is in defining certain taxes for the purpose of priorities and discharge. Under the Code, taxes are entitled to priority and are excepted from discharge if they constitute income taxes, property taxes, excise taxes, employment taxes, taxes required to be withheld by the debtor, and penalties on the same, so long as such penalties are "in compensation for actual pecuniary loss."[299] While the Code uses terms such as "excise" and "penalty," the Code does not define such terms, therefore leaving them to judicial interpretation.[300]

Several times, the Supreme Court has addressed the issue of whether a tax, as defined by state or federal law, is a tax for bankruptcy purposes. In deciding whether such a tax is entitled to priority in bankruptcy, the Court has applied a "functional" analysis, looking behind the statutory label given to the tax.

In two cases decided under the Act, the Court addressed whether certain state taxes were entitled to priority in bankruptcy. The Act provided for priority payment of "all taxes legally due and owing by the bankrupt to the United States, State, county, district, or municipality," before any distribution to creditors.[301]

In *New Jersey v. Anderson*[302] the Court held that a corporate franchise tax, imposed by a state upon corporations for the privilege of doing business within the state, was a tax for purposes of the Act. In its opinion the Court made three important statements about the proper role of state law in defining a creditor's entitlements in bankruptcy. First, the ultimate interpretation of the bankruptcy laws rests with the federal courts.[303] Second, while a state can certainly define its own taxes, a state cannot determine which of the

298. 140 CONG. REC. 27,696 (daily ed. Oct 4, 1994) (statement of Rep. Brooks). At least one commentator thinks that Congress did not go far enough in clarifying the cure provisions. *See*, Culhane, *supra* note 266, at 486 (explaining that the amendments only clarified the cure of defaults in home mortgages, not other long-term debts and that in failing to define "foreclosure sale" in the Code, Congress left the door open to arguments as to when a sale is completed under applicable nonbankruptcy law).

299. 11 U.S.C. §§ 507(a)(8), 523(a)(1) (1994).

300. *Id.*

301. Act of July 1, 1898, ch. 541, § 64(a), 30 Stat. 544 (repealed 1978).

302. 203 U.S. 483, 493 (1906).

303. *Id.* at 491.

payments that it receives constitute priority taxes for bankruptcy purposes.[304] Third, for bankruptcy purposes the term "tax" means "a pecuniary burden laid upon individuals or property for the purpose of supporting the Government."[305] Thus, the Court respected the ability of states to define taxes for their own purposes, but made the definition of taxes for bankruptcy purposes, specifically bankruptcy priority purposes, a question of federal law.

In *City of New York v. Feiring*,[306] the Court held that a New York City sales tax constituted a tax for bankruptcy purposes. The Court relied upon *Anderson* and added that because the Act's priority scheme was "[i]ntended to be nation-wide in its application," its scope should not be controlled by the various state law definitions of taxes.[307] The Court then examined relevant state law to determine whether the incidents of the sales tax were such that it should be defined as a tax for purposes of bankruptcy law.[308] It emphasized that it was not looking to state law to determine whether the state characterized the sales tax as a tax.

Yet another Supreme Court opinion about taxes and bankruptcy addressed the question of whether a federal tax was an excise tax for the purpose of priority in bankruptcy. Although in *United States v. Reorganized CF&I Fabricators of Utah, Inc*.[309] the Court addressed a conflict between the Bankruptcy Code and other federal law, the opinion is useful for its discussion of the role of state tax law in bankruptcy. The issue of whether a tax is an excise tax is an important one because excise taxes are entitled to priority under the Bankruptcy Code, while penalties other than those in compensation for actual pecuniary loss are not.[310] The Internal Revenue Service levied the tax at issue against the debtor on the accumulated funding deficiency of certain pension plans.[311] In holding that bankruptcy policy dictates whether a tax is an excise tax or a noncompensatory penalty, the Court first focused on the plain language of the Code and found no definition of "excise," "tax," or "excise tax."[312] The Court then noted several sections of the Bankruptcy Code in which Congress incorporated the definitions from other federal statutes by reference.[313] Because of the lack of such a specific

304. *Id*. at 492.
305. *Id*.
306. 313 U.S. 283, 288 (1941).
307. *Id*. at 285.
308. *Id*.
309. 518 U.S. 213, 215-16 (1996).
310. 11 U.S.C. § 507 (1994).
311. *Reorganized CF&I Fabricators*, 518 U.S. at 216.
312. *Id*. at 220.
313. *Id*. at 219.

reference in the tax priority sections of the Code, the Court embarked on the same functional analysis as the Court had done decades earlier in the *Anderson* and *Feiring* cases and found that the tax was in fact a penalty and thus not entitled to priority.[314]

In the tax cases, the federal courts have arrived at a uniform result applying federal common law. To date, Congress has not added a federal definition of "taxes" to the Code, although the Court in *Reorganized CF&I Fabricators* implied that it could do so.[315] Because of the Supreme Court's various pronouncements on the issue, the definition of taxes is a matter left to federal, not state law, consistent with the bankruptcy policies behind priorities. Further, because the Court has ruled that federal law governs the definition, it would certainly be within the power of Congress to define the term "tax" for the purpose of bankruptcy priorities and discharge.

VI. IF CONGRESS HAS THE POWER, WHY SHOULD CONGRESS EXERCISE IT?

Whether Congress can take action under the Bankruptcy Clause and whether it should are separate questions. In the case of purchase-money security interests, the law should be uniform because the federal interest in having a uniform law outweighs the interests of the individual states in having their own laws. Although some have pointed out that Congress should not exercise its power to fill gaps in federal laws solely in the interests of uniformity and policy,[316] the reasons for codifying the definition of purchase-money security interest for the purposes of consumer bankruptcy are so numerous that Congressional action is justified.

As illustrated earlier in this article, leaving the definition of "purchase-money security interest" to judicial resolution breeds tremendous uncertainty, which is undesirable as a matter of commercial law policy as well as of bankruptcy policy. One of the stated policies of the U.C.C. is to make the law uniform among the various jurisdictions.[317] Allowing courts to decide the meaning of "purchase-money security interest" does not further this policy. One stated bankruptcy policy is the fair treatment of creditors, whose claims

314. *Id*. at 226.

315. 518 U.S. at 219 (noting that Congress could have included a provision in the Bankruptcy Code calling the tax at issue an "excise tax").

316. O'Melveny & Myers v. FDIC, 512 U.S. 79, 88 (1994) (approving use of state law under Financial Institutions Reform, Recovery and Enforcement Act of 1989). *See also* Keatch, *supra* note 207, at 443-44.

317. U.C.C. § 1-102(1)(c) (2000).

should be considered in accordance with established principles.[318] In the area of purchase-money security interests, it is difficult to find any established principles in the decisions.

A. Federal Policy: Consumer Protection

The legislative history of the Code evinces a clear federal consumer protection policy behind the adoption of § 522(f).[319] Congress enacted § 522 (f) to prevent creditor overreaching. Congress recognized that the contracts signed by consumer debtors granting creditors non-purchase-money security interests in household goods are often contracts of adhesion, and by allowing consumer debtors to avoid such security interests, the Code allows consumers to avoid the harsh consequences of such contracts.[320]

After Congress enacted § 522(f), the Federal Trade Commission adopted its rule making it an unfair practice for a creditor to take a nonpossesory, non-purchase-money security interest in certain household goods.[321] One of the reasons that the FTC adopted this rule was to remove any special incentive for consumers to file for bankruptcy.[322] Because of this federal interest, the Bankruptcy Code should define the parameters of this overreaching by defining the point at which a security interest loses its purchase-money character.

In enacting §522(f), Congress recognized that creditors who take non-purchase-money security interests in low-value consumer goods probably do not expect any economic value from repossession. The legislative history of § 522(f) states that the purpose of the section is to allow debtors to avoid security interests that probably would not be enforced, because creditors who take security interests in household goods of little economic value rarely repossess them.[323] Again, these statements are evidence of the national consumer protection policy embodied in §522(f). The Supreme Court has stated that when a section of the bankruptcy laws is intended to be nationwide in its application, the terms and purposes of the bankruptcy laws should govern interpretation of the section.[324] Therefore, Congress should

---

318. H.R. REP. NO. 103-835, at 34 (1994), *reprinted in* 1994 U.S.C.C.A.N. 3340, 3341.

319. H.R. REP. NO. 95-595, at 127 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6088.

320. *Id*.

321. ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS: TEXT, CASES AND PROBLEMS 258 (3d ed. 1996) .

322. *Id*.

323. H.R. REP. NO. 95-595, at 127 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6088.

324. City of New York v. Feiring, 313 U.S. 283, 285 (1941) (defining the term "tax" for bankruptcy purposes).

take an additional step and define which interests qualify for this exalted status.

Several commentators have recognized the inadequacy of state law to address consumer issues. While some believe that special rules for consumers may be justified because many consumers are not equipped to bargain about or comprehend contracts to which they are parties,[325] those same commentators have explained that state law processes are ill-equipped to make uniformly applied rules.[326] For instance, fewer than one-quarter of the states have adopted the Uniform Consumer Credit Code.[327] In addition, recently the uniform laws process has not adequately protected consumer interests. Consumer issues are also hindering the final approval of Article 2 of the Uniform Commercial Code.[328]

The Code provides a form of consumer protection. Regional diversity in the application of the bankruptcy laws is at odds with the idea of consumer protection because the uneven application of the bankruptcy laws causes debtors in some parts of the country to receive less relief in bankruptcy than debtors in other parts of the country.[329] Application of Former Article 9 provides a case in point. Many courts begin their analyses of § 522(f) with the statement that because the Bankruptcy Code does not define "purchase-money security interest," courts must look to state law. The courts then apply former § 9-107, which leads them to different results.[330] In addition, relying on state law to define purchase-money security interests in consumer goods is misguided because the U.C.C. expressly refuses to decide the question where consumer goods are involved.

If the drafters of Revised Article 9 had defined the scope of a creditor's purchase-money security interest in consumer goods transactions, federal action would not be necessary. In considering whether a creditor had a purchase-money security interest in collateral, courts would look to a

---

325. Benfield, *supra* note 25, at 1255-56.

326. *Id*. at 1256; Miller, *supra* note 25, at 210-11. Scholars cite the differing social, economic, and political conditions in the states as the reasons for the inability of state law to come to a uniform resolution of consumer issues. Benfield, *supra* note 25, at 1256.

327. Eleven states, Colorado, Idaho, Indiana, Iowa, Kansas, Maine, Oklahoma, South Carolina, Utah, Wisconsin, and Wyoming, have enacted the Uniform Consumer Credit Code. *See* Benfield, *supra* note 25, at 1308.

328. Linda J. Rusch, *A History and Perspective of Revised Article 2: The Never Ending Saga of a Search for Balance*, 52 SMU L. REV. 1683 (1999).

329. *See* William C. Whitford, *The Ideal of Individualized Justice: Consumer Bankruptcy as Consumer Protection, and Consumer Protection in Consumer Bankruptcy*, 68 AM. BANKR. L.J. 397, 415 (1994).

330. *Compare* Gillie v. First State Bank of Morton, Tex. (*In re* Gillie), 96 B.R. 689, 693 (Bankr. N.D. Tex. 1989) (adopting transformation rule), *with* Bond's Jewelers, Inc. v. Linklater (*In re* Linklater), 48 B.R. 916, 919 (Bankr. D. Nev. 1985) (adopting dual-status rule).

uniform state law. Professor William Whitford has noted that deference to the U.C.C. in bankruptcy is not troubling from a consumer protection standpoint precisely because the U.C.C. is "substantially identical" from state to state.[331] However, the drafters of Revised Article 9 intentionally sacrificed certainty and uniformity for consumer support of the law. Thus, state commercial law in the area of purchase-money security interests does not conform to the stated goal of the U.C.C.

The reason for the "gaping hole" in the seam between the Uniform Commercial Code and the Bankruptcy Code is the consumer compromise, pursuant to which the drafters of Revised Article 9 retained the status quo regarding a number of consumer issues in exchange for the promises of both the business and consumer communities not to oppose the adoption of Revised Article 9 in the states.[332] As a result, while Revised Article 9 makes the law of secured transactions more nationally uniform in many respects,[333] it rejected uniformity for some consumer issues to achieve enactabililty.[334]

The consumer compromise has ensured that, in the absence of federal legislation, courts will continue to define the term "purchase-money security interest" in a non-uniform fashion when the collateral consists of consumer goods. Some states, in adopting Article 9, have rejected portions of the consumer compromise.[335] A federal definition of purchase-money security interest would preempt the operation of such state enactments in bankruptcy.[336]

The overall consumer protection policy in the Code is embodied in the fresh start. The fresh start for the "honest but unfortunate debtor"[337] is effectuated by the Code's grant of a discharge to individual debtors.[338] Because the discharge is a matter of federal policy, matters related to

---

331. Whitford, *supra* note 329, at 414 n.60.

332. *Braucher*, *supra* note 13, at 83.

333. *See, e.g.*, U.C.C. §9-501 (2000) (abolishing the dual filing regime of Former U.C.C. §9-401); *id*. § 9-103(f) (2000) (adopting the dual-status rule for determining the extent of a creditor's purchase-money security interest in non-consumer transactions); *id*. §9-626 (2000) (adopting the rebuttable presumption rule for calculating the amount of a deficiency in non-consumer transactions).

334. *Id*. at 83-85. *See also* the Consumers Union Web Site, *at* http://www.consumersunion.org/finance/summwc100.htm (last visited Jan. 22, 2001).

335. Maryland, Nebraska, and Tennessee all enacted non-uniform versions of §9-103, thereby codifying the dual-status rule and accompanying payment allocation formula for consumer goods transactions. *See* American Bar Association Business Law Section Joint Task Force on the Article 9 Enactment Process, *at* http://www.abanet.org/buslaw/cfs-ucc/uccarticle9/home.html (last visited Mar. 2, 2001).

336. *See* Hall v. Fin. One of Ga. (*In re* Hall), 752 F.2d 582, 586 (11th Cir. 1985) (noting that state's definition of non-exempt property is subject to federal preemption).

337. Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).

338. 11 U.S.C. §§ 727(a)(1), 1141(d), 1328 (1994).

dischargeability tend to be resolved by federal law. When the fresh start is considered paramount, the courts and Congress use bankruptcy law to determine property rights. As a result, the Code provides that a debtor can cure a home mortgage loan default until the time the property is sold, even if a state law provides that the debtor's equity of redemption is terminated earlier[339] and provides that the debtor can set aside a security interest otherwise enforceable under state law.[340] Because the debtor's ability to avoid security interests in bankruptcy is the ability to transform an otherwise nondischargeable secured debt into one which is likely to be discharged,[341] the scope of § 522(f) should be defined by federal law.

B. Federal Policy: Equal Treatment of Creditors

While many of the reasons advanced for federalizing the definition of purchase-money security interest are aimed at debtor protection, federal codification would also protect creditors. Another main bankruptcy policy is that of equal treatment of similarly situated creditors.[342] Secured transactions are rarely local in scope;[343] this statement applies to consumer as well as business transactions. The creditors in the lien avoidance cases are often national or regional creditors.[344] Consequently, a federal rule would reduce the necessity for those creditors to tailor their loan documentation to particular state laws. While these national creditors tailor their lending practices to state usury laws, it is unlikely that they use different definitions of purchase-money security interest in every state. In fact, "loan documentation" is not an accurate term for the paper associated with many security interests in consumer goods. A debtor can grant a security interest by signing a charge card receipt containing language such as, "I grant [creditor] a security interest in this merchandise until paid."[345] A debtor can also create a security interest by signing a charge card application that contains the statement, "[W]e retain a security interest under the Uniform Commercial

339. *See supra* Part V.C.2.

340. 11 U.S.C. § 522(f) (1994).

341. After bankruptcy, most unsecured debts are discharged. See 11 U.S.C. §523 (1994) for exceptions to discharge.

342. MARGARET HOWARD & PETER A. ALCES, CASES AND MATERIALS ON BANKRUPTCY 21 (2d ed. 2001).

343. Phillips, *supra* note 192, at 59.

344. *See, e.g.*, Breakiron v. Montgomery Ward (*In re* Breakiron), 32 B.R. 400, 400 (Bankr. W.D. Pa. 1983).

345. *In re* Carlos, 215 B.R. 52, 60 (C.D. Cal. 1997) (holding that such language on a charge slip did create a security interest).

Code in all merchandise charged to your account."[346] In the absence of a federal definition of "purchase-money security interest," a single creditor, such as a national department store chain, holding security interests created by identical charge card agreements likely would be treated differently by bankruptcy courts sitting in different states.

For creditors who make loans in a number of different states, a federal solution adds certainty to lending transactions. Because the primary purpose of taking a security interest is to guard against the risks of a borrower's bankruptcy, a national creditor might feel more certain that if it complies with a federal rule for creating a purchase-money security interest, it will preserve its priority in the debtor's property. Creditors are deemed to know the laws applicable in the jurisdictions in which they lend,[347] and it is more likely that a uniform federal definition of purchase-money security interest will be known to creditors doing business in a variety of jurisdictions. If the laws among the various states were truly uniform, then the creditors could achieve this certainty, but as the discussion earlier in this article shows, they are not.

C. The Role of Federalism in Bankruptcy Law

Throughout bankruptcy history, federalism has been cited as one reason for bankruptcy law's deference to state law. However, federalism concerns no longer constrain the federal government from legislating matters of commercial law.[348] In the early days of American bankruptcy law, there were pronounced geographical political differences in attitudes towards bankruptcy law. Congress passed the 1898 Act not long after the end of the Civil War, at a time when Southern lawmakers cared deeply about states' rights and Northern lawmakers wished to cement and extend the powers of the Union.[349] Legislators from the Northeast saw federal bankruptcy law as an essential catalyst for a national economy, while those from the South and West feared that such a law would jeopardize farmers' property.[350] In the years preceding passage of the Act, the Southern and Western states enacted

346. *In re* Ziluck, 139 B.R. 44, 46 (S.D. Fla. 1992).

347. *See* Rogers, *supra* note 196, at 987.

348. Lawrence J. Bugge, *Commercial Law, Federalism and the Future*, 17 DEL. J. CORP. L. 11, 21 (1992).

349. Charles Jordan Tabb, *A Century of Regress or Progress? A Political History of Bankruptcy Legislation in 1898 and 1998*, 15 BANKR. DEV. J. 343, 359-61 (1999).

350. David A. Skeel, Jr., *The Genius of the 1898 Bankruptcy Act*, 15 BANKR. DEV. J. 321, 324 (1999).

numerous pro-debtor laws, including generous exemption laws.[351]

In modern bankruptcy history, the debate over the role of state law in bankruptcy has continued. Property law is traditionally thought to be within the purview of state legislation, and during the debates over the Code in the late 1970s, states' rights advocates fought for the right to allow states to define exemptions in bankruptcy, while advocates of national uniformity advocated federal exemptions.[352] Congress reached a compromise between these two positions in adopting the opt-out.[353] While the National Bankruptcy Review Commission recommended that the opt-out be eliminated for personal property and that a floor and ceiling be placed on the operation of state homestead exemptions in bankruptcy, none of the bills introduced over the past few years have incorporated uniform exemptions.[354] Clearly, in the area of exemption laws, state interest continues to reign supreme.

While Congress has partially deferred to the states in the exemption arena, it designed the remainder of § 522 to be uniformly applied throughout the country.[355] While federalism plays a role in exemption law, it should not play a role in interpreting § 522(f), which specifically denies a creditor the right to assert a security interest in certain exempt property.[356] In states that have not opted out of the Code's exemptions, such exempt property is that which is exempt under either state law or the Code; in opt-out states, § 522 allows a debtor to take advantage of her state-created exemptions. A national approach to defining the extent of purchase-money security interests thus preserves the states' interest in defining exemptions while furthering an important federal consumer protection policy.

D. The Policies of the Uniform Commercial Code

Important state commercial law policies are embedded in the Uniform Commercial Code. All of the states have enacted at least some of the U.C.C. articles, making the U.C.C. the most successful uniform laws project in this

---

351. C. WARREN, *supra* note 188, at 149.

352. Davis v. Davis (*In re* Davis), 170 F.3d 475, 478 (5th Cir. 1999).

353. *Id*.

354. Bankruptcy Abuse Protection and Consumer Protection Act of 2001, S. 220, 107th Cong., H.R. 333, 107th Cong. (2001) (H.R. 333 passed in the House of Representatives on Mar. 1, 2001); Bankruptcy Reform Act of 2000, H.R. 2415, 106th Cong., S. 3186, 106th Cong. (passed both houses, pocket vetoed; President Clinton issued a Memorandum of Disapproval on Dec. 19, 2000); Bankruptcy Reform Act of 1999, H.R. 833, 106th Cong. (1999); Bankruptcy Reform Act of 1998, H.R. 3150, 105th Cong. (1998).

355. *See supra* note 333.

356. 11 U.S.C. § 522(f) (1994).

country.[357] By adopting the U.C.C., states have embraced the policy "to simplify, clarify and modernize the law governing commercial transactions."[358] The U.C.C., however, can clarify the law governing commercial transactions only when the answer to a commercial problem is found in the plain language of the U.C.C. When such an answer is not found in the U.C.C., transactions are less certain. One reason Revised Article 9 is much longer than existing Article 9 is that, in several places, Revised Article 9 codifies years of sometimes contradictory case law.[359] Because the existing version of Article 9 of the U.C.C. contributed to divergent judicial interpretations over the years, many see Revised Article 9 as clarifying the law of secured transactions.[360]

E. State Policy: Freedom of Contract

The state's policy interest in defining the extent of a purchase-money security interest might be to preserve freedom of contract, an important non-bankruptcy policy expressed in the common law of contracts[361] and in the U.C.C.[362] Creditors take security interests to guard against the risk of bankruptcy. Debtors give security interests because, in many cases, they can obtain loans on favorable terms only if they give collateral.[363] In many cases, it makes sense to preserve the creditor's bargain as created by state law. For the most part, the Bankruptcy Code does just that for secured creditors. In the area of purchase-money security interests in consumer goods, however, the bargain struck between the debtor and creditor is unclear. Even if one were to concede that the debtor intended to grant a purchase-money security interest, as explained before, in the consumer context such status does not matter for purposes of state law. Under state law, the important right of the secured creditor is the right to foreclose, and the secured creditor has that right whether the security interest is purchase-money or not. In the consumer context, the Bankruptcy Code has already limited a creditor's ability to do so

357. JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE, 4 (5th ed. 2000).

358. U.C.C. § 1-102(2)(a) (2000).

359. The number of default provisions of Article 9, located in Part 6 of Article 9, have increased by 300% over the number of default provisions in Former Article 9. For a detailed explanation of how Part 6 of Revised Article 9 has codified specific lines of case law, see TIMOTHY R. ZINNECKER, THE DEFAULT PROVISIONS OF REVISED ARTICLE 9 (1999).

360. *See, e.g.*, Steven O. Weise, *An Overview of Revised UCC Article 9*, *in* THE NEW ARTICLE 9, 1 (2d ed. 2000).

361. Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1404 (1985); 1 & 2 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS §§ 1.7, 5.1 (2d ed. 1998).

362. U.C.C. § 1-102(3), and cmt.3.

363. Steven L. Harris & Charles W. Mooney, Jr., *A Property-Based Theory of Security Interests: Taking Debtors' Choices Seriously*, 80 VA. L. REV. 2021, 2042-43 (1994).

when lending money in a consumer transaction.

The debtor's intent in granting a purchase-money security interest is important for purposes of federal law. Thomas Jackson, in his article discussing the fresh start policy, conceded that federal law might properly forbid a debtor from granting a non-purchase-money security interest in her household goods because of the fresh start policy.[364] He justified excepting purchase-money interests from the debtor's lien avoidance power because, in a purchase-money transaction, the debtor acquires the goods by waiving her exemption in the goods.[365] While it is true that the grant of a purchase-money security interest constitutes a waiver of the exemption under both state and federal law,[366] it is not clear that a consumer debtor has consciously granted a purchase-money security interest in refinancing and add-on debt transactions. Surely when consumers purchase goods on a revolving department store charge, they are unaware of whether the store applies a first-in, first out method of allocating payments or a pro-rata allocation, which can result in a cross-collateralized security interest.

In addition, parties cannot contractually remove their transactions from the reach of the Bankruptcy Code.[367] For example, courts have generally held that a debtor and creditor cannot agree, prior to the filing of a bankruptcy petition, that the creditor will not be subject to the automatic stay.[368] These courts held that because the automatic stay is designed to protect all creditors, the debtor and creditor are constrained by public policy from making contracts that purport to remove their transactions from the reach of the automatic stay.[369] Likewise, because, in the interest of consumer protection, Congress has given debtors the power to invalidate otherwise valid non-purchase-money security interests, a creditor should not be able to transform that non-purchase-money security interest into a purchase-money one by

364. Jackson, *supra* note 361, at 1436.

365. *Id.* at 1436-37.

366. Exemption statutes allow debtors to keep certain property from unsecured creditors. As a result, many statutes state that the "debtor's interest" in certain property is exempt. *See, e.g.*, 11 U.S.C. § 522(d) (1994). Others specifically provide that exempt property may be encumbered by a security interest. *See* TEX. PROP. CODE ANN. § 42.002(b) (Vernon 2000).

367. Norman v. Balt. & Ohio R.R., 294 U.S. 240, 307-08 (1935) ("Gold Clause Cases") ("Contracts may create rights of property, but when contracts deal with a subject matter which lies within the control of the Congress, they have a congenital infirmity. Parties cannot remove their transactions from the reach of dominant constitutional power by making contracts about them."); Juliet M. Moringiello, *A Mortgage by Any Other Name: A Plea for the Uniform Treatment of Installment Land Contracts and Mortgages Under the Bankruptcy Code*, 100 DICK. L. REV. 733, 771-72 (1996); Rogers, *supra* note 196, at 994-95.

368. *See, e.g.*, Farm Credit of Cent. Fla., ACA v. Polk, 160 B.R. 870, 873-74 (M.D. Fla. 1993); *In re* Sky Group Int'l, Inc., 108 B.R. 86, 88 (Bankr. W.D. Pa. 1989).

369. *Id.*

contract. This point should render constitutionally infirm all of the cases that determine whether or not the creditor's security interest is purchase-money based on the intent of the debtor and the creditor. While Revised Article 9 allows non-consumer debtors to agree to allocation provisions in their loan contracts, in doing so, the creditor is bargaining simply for priority vis-à-vis other creditors,[370] not ultimate priority in bankruptcy. When a creditor does so in a consumer contract, the creditor is bargaining ultimately for secured or unsecured status. Because the stakes in the consumer arena are so different, the creditors should not be able to dictate the extent of their purchase-money interests.

VII. CONCLUSION

Butner and its progeny, as well as many commentators, stress that the state law conceptions of property are important to uphold in bankruptcy to avoid debtors obtaining a windfall merely by reason of the happenstance of bankruptcy. In its lien avoidance provisions, however, the Code does provide debtors with such a windfall.

Even those scholars who adhere closely to the *Butner* principle concede that when an individual files for bankruptcy, it might be appropriate for bankruptcy to substantively affect a debtor's non-bankruptcy entitlements. Thomas Jackson, whose bankruptcy casebook opens with a discussion of the *Butner* principle,[371] described discharge as the embodiment of a "substantive bankruptcy policy designed to upset nonbankruptcy entitlements."[372] Professors Baird and Jackson state that one of the three purposes of the Code is to help individuals who are overburdened with debt.[373] To illustrate that this purpose does affect a debtor's substantive rights, they point to the fact that the Code makes an individual's future earnings immune from the claims of prepetition creditors.[374]

The judicial deference to state law in defining purchase-money security interests in consumer goods in bankruptcy hinders the application of a uniform bankruptcy policy to consumer debtors. The history of the consumer provisions in the Code indicates that Congress enacted § 522 to ensure that consumer debtors are given the "fresh start." Because laws furthering the

370. Subordination agreements are permitted under Article 9 of the U.C.C. §9-339. Such a subordination agreement is enforceable in bankruptcy. 11 U.S.C. § 510 (1994).

371. DOUGLAS G. Baird et al., BANKRUPTCY: CASES, PROBLEMS AND MATERIALS (Foundation Press, 3d ed. 2000) [hereinafter BAIRD CASEBOOK].

372. JACKSON, LOGIC AND LIMITS, *supra* note 155, at 225.

373. BAIRD CASEBOOK, *supra* note 371, at 21.

374. *Id.* at 28.

fresh start policy are clearly within the purview of Congress' power under the Bankruptcy Clause and because there is little, if any, state interest in defining the scope of a purchase-money security interest in consumer goods, Congress should fill in the blank and define the term "purchase-money security interest" in the Bankruptcy Code.