IN THE UNITED STATES BANKRUPTCY COURT
FOR THE SOUTHERN DISTRICT OF ILLINOIS

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| IN RE: | ) | In Proceedings |
| | ) | Under Chapter 7 |
| LAVERNE STONE and | ) | |
| BETTY STONE, | ) | |
| | ) | No. BK 88-50608 |
| Debtor(s). | ) | |
| | ) | |
| WOOD RIVER FURNITURE | ) | |
| MART, INC., | ) | |
| | ) | |
| Creditor. | ) | |

MEMORANDUM AND ORDER

This matter is before the Court on debtors' Motion to Avoid Security Interest in Exempt Property and on the response thereto filed by Wood River Furniture Mart, Inc., ("Wood River"). Debtors seek to avoid Wood River's security interest in certain personal and household goods pursuant to section 522(f) of the Bankruptcy Code, claiming that the security interest so held is a "nonpossessory, nonpurchase-money security interest." 11 U.S.C. §522(f). In response, Wood River contends that its security interest is a purchase money security interest, and that as such, its lien cannot be avoided.

Debtors purchased eighteen items of personal property from Wood River between 1983 and 1987. The parties apparently entered into a separate retail contract for each purchase. The item or items sold were also listed on a separate sales ticket. The various sales tickets, with identifying numbers, are attached as exhibits to Wood River's response. Likewise, Wood River has supplied a copy of a retail installment contract dated September 26, 1986, evidencing the purchase of three particular items, and a

copy of a retail installment contract dated February 25, 1987, evidencing a refinancing arrangement between the parties. However, at the hearing on this matter, Wood River, through its counsel, informed the Court that it no longer has copies of any of the other retail installment agreements.

Section 522(f) of the Bankruptcy Code provides, in part, as follows:

> [T]he debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section, if such lien is ....
>
> > (2) a nonpossessory, nonpurchase-money security interest in any --
> >
> > > (A) household furnishings, household goods...that are held primarily for the personal, family, or household use of the debtor or a dependent of the debtor....

11 U.S.C. §522(f). The Bankruptcy Code does not define "purchase money security interest," and the courts have therefore looked to the law of the state in which the security interest is created for the appropriate definition. In re Billings, 838 F.2d 405, 406 (10th Cir. 1988); Pristas v. Landaus of Plymouth, Inc., 742 F.2d 797, 800 (3d Cir. 1984). The Illinois Uniform Commercial Code defines "purchase money security interest" as follows:

> A security interest is a "purchase money security interest" to the extent that it is
>
> > (a) taken or retained by the seller of the collateral to secure all or part of its price; or

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

Ill.Rev.Stat. ch. 26, ¶9-107. "In sum, a purchase-money security interest exists if the collateral is the item purchased and it secures its own price." Pristas, 742 F.2d at 800.

In the present case, the September 26, 1986 retail installment contract provided for the purchase of a bed frame, box springs and mattress. Those items are listed under a section of the contract entitled "Description and identification of Merchandise and/or Services." Under that same section, reference is made to "additional chattels" previously purchased and to the numbers of individual sales tickets that contain a description of those chattels. Debtors argue that "the attempted consolidation in the September Retail Installment Contract of a Purchase Money Security Interest in both the item purchased...and all previous items purchased, without any evidence of a Retail Installment Contract in regard to those purchases, does not create a Purchase Money Security Interest in those prior purchases." (Debtors' Memorandum, p. 2). Debtors later refer to "an attempted consolidation of... previously purchased unsecured items with an item purchased pursuant to an attempted Purchase Money Security Agreement...." (Debtors' Memorandum, p. 2)(emphasis added).

Although far from clear, debtors appear to argue that the purchases made prior to September 26, 1986 were unsecured transactions. At the hearing on this matter, however, counsel for debtors did not

dispute the facts as set forth by Wood River's counsel, i.e., that the parties entered into a separate retail installment contract for each purchase. Moreover, in their Motion to Avoid Security Interest in Exempt Property, debtors admit that Wood River has a "security interest" in the items at issue (though they do contest whether such is a purchase money security interest), and specifically request that they be allowed to avoid this security interest. Debtors' argument is therefore without merit.

Debtors' argument may also be construed in an alternative manner. Apparently, each time an item was purchased, the number and amount of payments were recalculated to include the amount owed for prior purchases and the amount owed on the new purchase. In other words, the amount owed on the newly purchased item was consolidated with the amount owed on previous purchases and the installment payment increased accordingly. Thus, the total payments owed under the September 26, 1986 contract included amounts due on all prior purchases, as well as the amount due on the newest purchase. In addition, the contract provided that the "[s]eller retains and shall have a purchase-money security interest in the property described above...until the Total of Payments and all other amounts hereafter to become due from Buyer hereunder are paid in full." The "property described above" consists of both the newly acquired item and those items purchased prior to September 1986. Debtors, therefore, may be arguing that consolidation of the underlying debts destroys the purchase money status of the creditor's security interest since, under the contract language quoted above, any one item of collateral appears to secure not only its own

price, but also that of other items. Debtors' argument "expresses a concern for determining at what point in the reduction of the indebtedness a particular piece of collateral is released from the purchase money encumbrance." In re Sprague, 29 B.R. 711, 712 (Bankr. M.D. Pa. 1983), aff'd Pristas v. Landaus of Plymouth, Inc., 742 F.2d 797 (3d Cir. 1984). In other words, "if no sequence is provided for the release of the encumbrance in the individual items of collateral, the creditor will continue to retain a purchase money security interest in each item until the entire indebtedness is satisfied." Id. at 713.

A number of courts have addressed the issue now before this Court, i.e., whether a purchase money security interest in goods remains effective when the indebtedness underlying that interest is consolidated with that of a subsequent purchase money security interest. The courts have reached varying results. Some have adopted the "transformation rule," which holds that "if an item of collateral purports to secure not only its own purchase price but also that of other items, the security interest that existed before the 'add on' [debt] is transformed into nonpurchase-money status." Pristas, 742 F.2d at 800. See, e.g., In re Manuel, 507 F.2d 990 (5th Cir. 1975); In re Norrell, 426 F.Supp. 435 (D.C. Ga. 1977); In re Scott, 5 B.R. 37 (Bankr. M.D. Pa. 1980); In re Mulchay, 3 B.R. 454 (Bankr. S.D. Ind. 1980). Other courts hold that a security interest can have a "dual status." See, e.g., Pristas, 742 F.2d at 800; In re Moore, 33 B.R. 72 (Bankr. D. Ore. 1983); In re Gibson, 16 B.R. 257 (Bankr. D. Kan. 1981). The "dual status" rule is premised on the language of section 9-107 of the Uniform Commercial Code, which provides that a security interest is

a purchase money security interest "to the extent that it is taken or retained by the seller of the collateral to secure all or part of its price...." Ill.Rev.Stat. ch. 26, ¶9-107 (emphasis added). "Thus, a purchase-money security interest in a quantity of goods can remain such 'to the extent' it secures the price of that item, even though it may also secure the payment of other articles." Pristas, 742 F.2d at 801.

This Court agrees with those decisions that have adopted the "dual status" rule. As repeatedly noted in the decisions adopting this rule, the phrase "to the extent" in section 9-107 of the Uniform Commercial Code would be meaningless if a secured debt could never be divided into two parts, i.e., "a purchase money part constituting so much of the debt as represents the price of the [collateral]...and a nonpurchase money part constituting the 'add on' debt." In re Gibson, 16 B.R. at 257. Furthermore, application of the "dual status" rule readily comports with the general business practices in that it simplifies repeat transactions between the same buyer and seller.

To apply the "dual status" rule, however, the extent to which a particular item continues to secure its own price and the extent to which payment of other purchases is affected must first be determined. In the present case, the contract itself does not specify how the payments are to be allocated. However, state law, either statutory or decisional, may be considered to determine the method of allocation when the contract is silent on this point. Pristas, 742 F.2d at 801-02. The Illinois Retail Installment Sales Act provides the method of allocation to be applied in such instances. Paragraph 522 of that Act provides, in part, as follows:

> When subsequent purchases are made, if the seller has retained or taken a security interest in any of the goods purchased under any one of the contracts included in the consolidation he
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> (1) shall apply the entire amount of all payments made before the subsequent purchases to the previous purchases;
>
> (2) shall allocate each payment on the consolidated contract after the subsequent purchases to all of the various purchases in the same ratio as the original cash sale prices of the various purchases bear to the total of all;
>
> (3) may, at his option, where the amount of each installment payment is increased in connection with a subsequent purchase, allocate the subsequent payments by applying an amount equal to the original periodic payment to the previous purchase and the balance to the subsequent purchase. However, he must allocate the amount of any down payment on the subsequent purchase in its entirety to the subsequent purchase.

Ill.Rev.Stat. ch. 121 1/2, ¶522. Since apportionment of payments is possible, Wood River's purchase money security interest is preserved. Its security interest can be avoided under section 522(f) only to the extent that it is nonpurchase money security.[1]

Likewise, the February 27, 1987 refinancing agreement, apparently executed to lower debtors' monthly payments, does not destroy Wood River's purchase money security interest. Again, the courts have reached varying results when considering the question of whether refinancing agreements extinguish the purchase money character of an

[1]Without further evidence, the Court cannot, at this time, determine what portion of the total obligation, if any, may be voided under section 522(f).

obligation. Those decisions adopting the "transformation rule" and holding that the purchase money security interest is extinguished include Dominion Bank of Cumberlands v. Nuckolls, 780 F.2d 408 (4th Cir. 1985) and Matthews v. Transamerica Financial Services, 724 F.2d 798 (9th Cir. 1984). This Court, however, agrees with those decisions which hold that a refinancing agreement does not automatically transform the purchase money security interest into a nonpurchase money security interest.[2] As stated in In re Billings, 838 F.2d 405 (10th Cir. 1988), "[w]hen a debt secured by a purchase money security interest is refinanced, and the identical collateral remains as security for the refinanced debt, then neither the debt nor the security has changed its essential character." Id. at 410. See also In re Hansen, 85 B.R. 821, 828-29 (Bankr. N.D. Iowa 1988); In re Hemingson, 84 B.R. 604, 607-08 (Bankr. D. Minn. 1988); In re Gayhart, 33 B.R. 699, 700-01 (Bankr. N.D. Ill. 1983). Policy reasons, well summarized by the Tenth Circuit as follows, clearly dictate such a result:

> The basic problem with the automatic "transformation" rule is that it discourages creditors who have purchase money security interests from helping their debtors work out of financial problems without bankruptcy and without surrendering the collateral security the debt. The instant case is an excellent example. These debtors apparently need lower monthly payments on their debt. In a "transformation" jurisdiction the creditor could not cooperate without giving up its rights to protect its security if debtors

[2]Debtors admits in their Memorandum that "the bankruptcy courts have consistently held that a mere refinancing does not destroy the Purchase Money Security Interest character of the agreement." (Debtors' Memorandum, p. 3).

filed bankruptcy.

In re Billings, 838 F.2d at 409.

Accordingly, for the reasons stated, debtors' Motion to Avoid Security Interest in Exempt Property is DENIED.

_____/s/ Kenneth J. Meyers
U.S. BANKRUPTCY JUDGE

ENTERED: April 18, 1989