In the United States Bankruptcy Court

for the Northern District of Iowa

PAUL DAVID BISHOP, TERESA JANE BISHOP Debtor(s).	Bankruptcy No. 93-60176LW Chapter 7

ORDER

On September 15, 1993, the above-captioned matter came on for further hearing pursuant to assignment. Debtors Paul and Teresa Bishop appeared in person with Attorney Michael Dunbar. Also appearing was Creditor First National Bank of West Union with its attorney, Jeffrey Clements. Evidence was presented after which the Court took the matter under advisement.

STATEMENT OF THE CASE

Debtors filed a Chapter 7 Petition in Bankruptcy on February 5, 1993. Debtors filed a Motion for Lien Avoidance on March 31, 1993 to which Creditor First National Bank of West Union (the Bank) filed a resistance on April 21, 1993. Trial was held on these matters on May 26, 1993 and a ruling was filed June 29, 1993. That ruling placed the burden of proof on Debtors to establish all elements of 11 U.S.C. 522(f). With the exception of certain items, the Court determined that Debtors had not met their burden. The Bank's interest in the remainder of the property was deemed to be subject to a purchase money security interest and the liens were not avoided on that property. Debtors moved for a new trial. The Court allowed a reopening of the record to present additional evidence to determine whether the Bank has a purchase money security interest in certain items of farm machinery.

FINDINGS OF FACT

Exhibit #1 was offered into evidence, without objection by Debtors. It is a compilation of all of the items of farm machinery purchased while Debtors were engaged in the farming operation. It sets out the existence or non-existence of purchase money security interests in eleven loans. There was later consolidation and rewriting of these various obligations. The Bank concedes that all items of equipment in this Exhibit are in fact not encumbered by purchase money security interests with the exception of eight loan transactions involving the following items of machinery: a) 1974 tractor; b) skid loader; c) stacker and mover; d) steel bale racks and gears; e) six bottom plow; f) JD 54 spreader; g) baler with thrower; h) hydraulic mix mill; i) haybine; and j) combine. Only liens involving this machinery are in controversy in this trial.

Debtors agree that the Bank loaned them money to purchase these items and that the Bank took those items as security for the various loans at the time the items were purchased. Of these items, Mr. Bishop testified that the hydraulic mix mill was in his physical possession until the time that he left the farming operation in Lansing. It was purchased on April 23, 1987 (Loan No. 49545). Mr. Bishop sold the hydraulic mix mill to the individual who took over his farming operation. Debtors do not seek to avoid the lien on the mix mill because of this sale.

The combine (Loan No. 48187) was purchased for $10,000. A downpayment was provided by the Bank in the amount of $2,400. The difference between the downpayment and the total cost was financed through Massey Ferguson by a lender known as Agricultural Acceptance Credit Corporation. Debtor testified that the payments to Ag Acceptance Credit Corp. were made regularly and were eventually paid off in full. The downpayment of $2,400 remained due and owing to the Bank though Debtor testified that this was also eventually paid off. However, it was not paid off until it passed through a series of consolidation loans. At the time of the first consolidation loan, many of the original notes were due or coming due. At the time of consolidation, new security agreements were drafted which included all of the machinery as well as livestock.

The first consolidation loan (Loan No. 50359) was dated August 13, 1987. At that time, there was approximately $2,500 due and owing on the combine (Loan No. 48187). The consolidation loan (Loan No. 50359) was in the total amount of $46,200. This consolidated previous obligations and, while the Debtor was unclear whether additional cash was received in the consolidation, the evidentiary record supports the fact that cash above the total of the consolidations was received though the exact amount is not established. The interest rate was set at 12.9% which is lower than the interest rate in earlier individual Notes. Additionally, the payment schedule changed under the new Note (Loan No. 50359). It was to be paid off by payments consisting of 25% of the Debtor's milk check. At the time of the execution of the consolidation loan, all of the previous loans and old Notes were marked paid and were returned to Debtors.

Additional consolidation loans followed. The second consolidation loan was executed March 16, 1989; slightly more than one year after the first consolidation. In the second consolidation, Debtors received additional cash of $13,000 and the interest rate decreased nominally.

The third consolidation loan (Loan No. 56396) was executed March 2, 1990. This was the following year's rewrite of the previous consolidation loan of all Notes at the Bank. The evidence does not establish if additional cash was advanced.

Finally, Debtors consolidated in 1991 (Loan No. 61179). Additional cash was advanced and the interest rate dropped to 11.25%. This was the lowest rate ever received.

Debtors claim that the purchase money nature of the individual loans was extinguished by the consolidation loan of August 13, 1987. They argue that even if the purchase money character was not extinguished by the initial consolidation loan, it certainly was based on the second, third or fourth consolidation.

The Bank states that these various consolidations were done at the behest of the Debtors. It asserts that it was faced with either foreclosing on the collateral or consolidating the various loans and allowing the Debtors to have more time to repay. The Bank argues that these consolidations were largely done for the benefit of the Debtors and consolidation does not eliminate the purchase money character of the original Notes. The Bank claims Debtors are urging utilization of the "transformation rule". The Bank states that the case of In re Marian Hansen, 85 B.R. 821 (Bankr. N.D. Iowa 1988), establishes that the "transformation rule" is not appropriate as it would discourage bankers from continuing to work with their debtors. The Bank finally claims that it was working with Debtors to help them and when a bank is working with the debtor, the security interest of the bank should be protected on equitable grounds.

Debtors state that even if the foregoing is correct and the liens are not avoided, the Debtors will not receive credit for the pay down which has occurred. While Debtors do not agree with the Bank's position, they claim that if the foregoing is accepted by the Court, they should receive credit for payments made on these various transactions over the years.

CONCLUSIONS OF LAW AND ORDER

Debtors argue that the facts establish a novation as defined by Iowa and Bankruptcy law. The Bank argues that Debtors are urging application of the "transformation rule" which is not recognized in the Northern District of Iowa. It appears appropriate to discuss the meaning of these respective legal principles prior to a determination of their applicability in this case.

As set forth in the Court's previous ruling, a novation is a contract that is accepted by the obligee in satisfaction of the obligor's duty. In re Marian Hansen, 85 B.R. at 826. The burden is on the party asserting a novation to establish all of the requisite elements. The burden of proof is by clear and satisfactory evidence. Eitzen's Estate v. Lauman, 231 Iowa 1169, 3 N.W.2d 546 (1942); In re Hassebroek, 136 B.R. 527 (Bankr. N.D. Iowa 1991). A novation is never presumed. The elements necessary to establish a novation are: a) parties capable of contracting; b) a valid prior obligation to be displaced; c) consent of all parties to the substitution, based on sufficient consideration; and d) extinction of the old obligation and the creation of a new one. Wade & Wade v. Central Broadcasting Co., 227 Iowa 422, 288 N.W. 439

(1939); Himmelberger v. Central State Bank (In re Talbott's Estate), 209 Iowa 1, 224 N.W. 550 (1929); In re Hassebroek, 136 B.R. 527 (Bankr. N.D. Iowa 1991).

The critical element in considering whether a novation has been established is the intent of the parties. A determination must be made whether the parties intended to extinguish the old obligation and rely on the new contract. In re Marian Hansen, 85 B.R. at 826; In re Hassebroek, 136 B.R. at 531.

Various factors are considered in determining the intention of the parties, including: a) whether new money was advanced in the new contract; b) whether the debtor's payments were increased; c) whether additional collateral was provided; d) whether a new security agreement was executed; and e) whether the original loan obligations were extinguished. In re Marian Hansen, 85 B.R. at 827; In re Hassebroek, 136 B.R. at 531.

If the requisite elements of a novation are established by clear and satisfactory evidence, the novation stands as a substituted contract, the parties obligations existing under the original contract are satisfied by the novation, and the party's current obligations are completely controlled by the novation. In re Marian Hansen, 85 B.R. at 826.

The Bank argues Debtors are urging application of the "transformation rule". Prior to discussion of its applicability, the Court will discuss its meaning in the bankruptcy context.

Some Courts 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' procedures is transformed into nonpurchase- money status. Those Courts reason that because the item secures more than its own price, there is no longer a 'pure' purchase-money security interest and consequently that lien disappears.

Pristas v. Landaus of Plymouth, Inc., 742 F.2d 797, 800 (3d Cir. 1984), citing In re Manuel, 407 F.2d 990 (5th Cir. 1975); In re Norrell, 426 F. Supp. 435 (D. Ga. 1977); In re Krulick, 6 B.R. 443 (Bankr. M.D. Tenn. 1980); In re Scott, 5 B.R. 37 (Bankr. M.D. Penn. 1980); In re Mulcahy, 3 B.R. 454 (Bankr. S.D. Ind. 1980).

Another rule which requires definition to complete analysis of these issues is the "dual status" rule. This rule holds that even though a loan transaction may contain items of collateral which secure not only its own purchase price but also the purchase price of other items, a purchase money security interest is not necessarily transformed into a non-purchase money security interest. Pristas, 742 F.2d at 800-01. This interpretation is drawn from the Uniform Commercial Code language incorporated into Iowa law in Iowa Code sec. 554.9107 which states: "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." (emphasis added) This is interpreted to mean that the consolidation of various purchase money security transactions does not destroy the purchase money security character of each individual transaction, but rather a purchase money security interest survives to the extent that it secures the price of a particular article of property.

The foregoing definitions provide a framework for analysis in this case. Debtors argue that a novation has occurred because of four consolidation loans. The Bank claims Debtors are urging utilization of the "transformation rule". The Bank argues the "transformation rule" penalizes a creditor who is attempting to help a Debtor meet its loan obligations. Both parties are correct in their legal analysis. However, it is the finding of this Court that the Bank's comparison is inaccurate. The Bank asks the Court to compare the doctrines of novation and the "transformation rule". However, a novation is governed by contract principles and is solely a creature of contract law. It is independent of both the "transformation rule" and the "dual status rule". Instead of comparing the "transformation rule" to the doctrine of novation, the appropriate comparison is between the "transformation rule" and the "dual status rule".

To properly frame the analysis, the Court must first determine whether Debtors have established a novation by clear and satisfactory evidence. If Debtors have proven a novation, the analysis terminates because a new contract has come into existence and the purchase money security character of the transaction has terminated. However, even if a novation is not established, the Debtors still can seek a determination of whether the "transformation rule" or the "dual status rule" should be applied. In practice, the comparison between the "transformation rule" and the "dual status rule" has already been determined in the Northern District of Iowa. In re Hassebroek, 136 B.R. at 531. The Bank is correct in arguing the Northern District of Iowa has rejected the "transformation rule" in favor of the "dual status rule" which, under appropriate circumstances, allows a determination of the extent to which a particular item continues to secure its own price. Pristas, 742 F.2d at 801. As the "transformation rule" and the "dual status rule" are creatures of bankruptcy law, the appropriate burden of proof is upon debtor by a preponderance of the evidence.

To summarize, the appropriate analytical approach is to first address Debtors' claim of a novation contract. If the novation is established by clear and satisfactory evidence, a new contract is created and the purchase money security interest terminates. However, if a novation is not established by clear and satisfactory evidence, Debtors retain the right, and the burden of proof, to establish application of the "dual status rule" under the lesser standard of preponderance of the evidence. Applying this framework, the Court will first consider Debtors' claim of novation.

The record establishes that many items of farm machinery were purchased by Debtors over an extended period of time. Initially, each item was purchased and financed by the Bank on separate notes. This method of financing continued until August of 1987 when the first consolidation loan occurred. In this transaction, all of the individual notes were consolidated. The previous loans and notes were marked paid and returned to Debtors. New security agreements were drafted. The loan of August 13, 1987 contained an additional infusion of cash. Several, if not all of the subsequent consolidation loans, contained the advancement of new cash. The terms of the payment schedule were changed as was the interest rate, though the interest rates were decreased with each successive loan. It appears that the Bank took additional collateral at the time of the consolidation loan when Debtors' livestock was included in the security agreement.

As stated, a novation must be established by clear and satisfactory evidence. The controlling element in a determination of a novation is the intent of the parties and whether it was their desire to extinguish the old obligation and create a new one. The Court previously discussed the factors utilized in analyzing the issue of intent. It is the conclusion of this Court that many, if not all of those factors, are present in this case. The evidence establishes that throughout the course of the four consolidation loans, there was a continual infusion of additional cash. There is the indication that additional collateral was provided by the inclusion of the cattle in the consolidated security agreement. There were changes in the terms of the loan transaction including changes in the interest rate and changes in the nature of the payment schedule. The original notes were marked paid and new security agreements were drafted. None of the new notes or security agreements describe this set of transactions as a renewal or a continuation of the prior obligations. Finally, while not conclusive, the intent of the parties is shown to some extent by the fact that no formula was included in the consolidation loan whereby monthly payments under the consolidation loan would be allocated to the previous individual loan transactions.

The Court has reviewed the entire record made at the May 26, 1993 trial as well as the September 15, 1993 trial. It is the ultimate conclusion of this Court that the Debtors have established, by clear and satisfactory evidence, that the parties intended, based on the foregoing factors, that the consolidation loans extinguish the individual loan transactions and create a new contract. A novation has occurred and the security interest obtained under the first consolidation loan (Loan No. 50359) and subsequent consolidation loans is not a purchase money security interest under 554.9107 of the Uniform Commercial Code. The consolidation loan of August 13, 1987 extinguished the purchase money security character of the original individual notes.

Because a novation has been established by clear and satisfactory evidence, the Court need not address the application of subsequent payments under the consolidation loans to the remaining balances under the "dual status rule". However, if this Court were to make such a determination, it would apply the "dual status rule" as opposed to the "transformation rule". The Court concurs with the Bank that the "transformation rule" is rejected in the Northern District of Iowa. Finally, if the Court were to reach the "dual status" issue, the Court would apply the stream of payments analysis using the first in, first out method of allocating payments to the debt (FIFO). Pristas v. Landaus of Plymouth, Inc., 742 F.2d 797, 801 (3d Cir. 1984); In re Hassebroek, 136 B.R. 527 (Bankr. N.D. Iowa 1990); In re Hemingson, 84 B.R. 604 (Bankr. D. Minn. 1988); In re Butler, No. 86-0165C (Bankr. N.D. Iowa May 28, 1987).

In summary, Debtors have established a novation by clear and satisfactory evidence, whereby the purchase money character of the Bank's security interest has been lost through a consolidation loan occurring on August 13, 1987. Based upon this novation, the Bank does not have a purchase money security interest in any of the items listed with the exception of the hydraulic mix mill to which the Debtors do not seek to avoid the lien because of a prior sale.

For clarification, the Court reminds the parties that it previously found that Mr. Baumler's opinion as to the value of the various items of machinery was accepted. The Court continues to make such a determination and Mr. Baumler's opinion as to value on all of the items of machinery shall be this Court's determination as to value. Pursuant to sec. 627.6(11)(a) of the Iowa Code, the exemption is limited to the sum of $10,000 for an individual debtor or $20,000 for joint debtors.

WHEREFORE, it is the finding of this Court that the Debtor has established by clear and satisfactory evidence that there is a novation and that the purchase money nature of the Bank's security interest is eliminated.

FURTHER, it is ordered that judgment shall enter that the security interest of First National Bank of West Union is avoided to the extent of $20,000 for the joint debtors in the 1974 tractor; skid loader; stacker and mover; steel bale racks and gears; six bottom plow; JD 54 spreader; baler with thrower; haybine; mower; and combine.

FURTHER, for the reasons set forth herein, the lien is not avoided in the hydraulic mix mill.

SO ORDERED this 21st day of October, 1993.

Paul J. Kilburg, Judge
U.S. Bankruptcy Court