

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

IN RE:) In Proceedings
) Under Chapter 13
MELINDA & STEVEN MCHUGHS,)
) No. BK 94-40176
)
Debtor(s).)

OPINION

At issue in this chapter 13 proceeding is whether a written agreement entered into between Cook Sales, Inc. ("Cook") and debtors for the lease of a portable warehouse is a true lease subject to assumption or rejection under 11 U.S.C. § 365 or a disguised security agreement. The relevant facts are as follows:

On March 2, 1992, debtor Melinda McHughs and Cook executed a written document entitled "Portable Warehouse Lease" (hereafter referred to as "the lease"). The term of the lease is thirty-six months, and provides for monthly payments (including sales tax of \$2.48) of \$71.69. The warehouse was delivered to debtors at their residence and remains in their possession. On March 9, 1994, debtors filed a chapter 13 bankruptcy petition. Cook filed an unsecured priority claim in the amount of \$336.76, consisting of approximately \$190.56 in pre-petition lease payments and \$146.20 in late charges.

In their plan, debtors treat Cook's claim as secured and propose to pay Cook the sum of \$300.00 plus interest at the rate of ten percent. Cook objects to confirmation of the plan on the basis that it fails to comply with 11 U.S.C. § 1322(b)(7).¹ Cook

¹Section 1322 provides that "the plan may ... subject to section 365 of this title, provide for the assumption, rejection, or assignment of any executory contract or unexpired lease of the debtor not previously rejected under such section...." 11 U.S.C. §

specifically contends that the plan violates section 365 of the Bankruptcy Code by improperly classifying Cook's claim as secured and by proposing to retain possession of the warehouse without curing existing defaults and without providing adequate assurance of the debtors' future performance under the lease.

The existence, nature and extent of a security interest in property is governed by state law. In re Powers, 983 F.2d 88, 90 (7th Cir. 1993) (citations omitted) . Section 1-201(37) of the Illinois Uniform Commercial Code, amended in 1991, provides:

(37) "Security interest" means an interest in personal property or fixtures which secures payment or performance of an obligation....

Whether a transaction creates a lease or security interest is determined by the facts of each case; however, a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee; and

(a) the original term of the lease is equal to or greater than the remaining economic life of the goods;

(b) the lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods;

(c) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement; or

(d) the lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

A transaction does not create a security interest

1322(b)(7).

merely because it provides that:

(a) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into;

(b) the lessee assumes risk of loss of the goods, or agrees to pay taxes, insurance, filing, recording, or registration fees, or service or maintenance costs with respect to the goods;

(c) the lessee has an option to renew the lease or to become the owner of the goods;

(d) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market rent for the use of the goods for the term of the renewal at the time the option is to be performed; or

(e) the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.

810 ILCS 5/1-201(37) (emphasis added).²

Section 1-201(37) focuses on the economics of the transaction, not the intent of the parties. In re Lerch, 147 B.R. 455, 460

² Amended section 1-201(37) became effective on January 1, 1992. It applies to the instant case since the lease in question was executed in March 1992. Prior to its amendment, the statute provided, in pertinent part, as follows:

Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.

Ill. Rev. Stat. ch. 26, ¶ 1-201(37).

Bankr. C.D. Ill. 1992) . The statute consists of several different standards to be used in determining whether an agreement is a true lease. In re Lerch explains the manner in which these standards are to be applied:

The initial portion of the first sentence of the second unnumbered paragraph contains the basic direction that the determination is made based on the facts of each case. The latter portion of the first sentence ... starting with the word "however" creates an exception to the basic direction that the determination is made on the facts of each case, as it provides that without looking at all the facts, a lease will be construed as a security interest if a debtor cannot terminate the lease, and if one of the four enumerated terms is present in the lease.

Absent a mandated classification, the determination is based on the facts of the case. At this point the third unnumbered paragraph comes into effect. Focusing on the economics of the transaction, it states that a security interest is not created merely because it contains any of the five terms enumerated in the third unnumbered paragraph.

Id. at 460.

Accordingly, the Court must first decide whether the lease constitutes a security agreement as a matter of law under section 1-201(37). In other words, "i[t] must first be determined whether the transaction falls within the mandated definition of security interest set forth in the second paragraph of section 1-201(37)." In re Zaleha, 159 B.R. 581, 584 (Bankr. D. Idaho 1993). The first element of that definition requires that the lessee must be obligated to perform for the full length of the lease without being able to voluntarily terminate the lease. Id. at 584 (emphasis added). That condition is not met in the present case. Paragraph six of the lease grants the lessee an option to terminate and specifically

provides that "[t]he lessee may terminate this lease at any time by written notice to Lessor and Lessee shall have no obligation to Lessor subsequent to the date of the notice except for liability for damage to the leased property during the lease term." In light of this provision, the lease does not satisfy the legal definition of security interest set forth in the second paragraph of section 1-201(37). The Court, then, must evaluate the nature of the transaction by considering the facts of the case, keeping in mind the additional factors listed in paragraph three of the statute. See In re Zaleha, 159 B.R. at 584; In re Lerch, 147 B.R. at 460.

Debtors argue that because the lease contains an option to purchase for nominal consideration, the lease is a disguised security agreement. Paragraph seven of the lease provides:

In the event the Lessee pays 12 or more monthly lease payments and the Lessee is not in default, Lessee shall have the exclusive right and option, at any time thereafter while such lease is in force, to purchase the leased property for cash in the amount of \$1,495.00; 60% of all previously made rental payments (but not sales tax included in payments) will apply toward the purchase price. Sales tax will be taken out of each rental payment on the equity amount (60%) or 1/36th of total sales tax due each month.

The Courts have consistently held that the inclusion of an option to purchase for nominal consideration indicates that the transaction should be treated as a security agreement. See, e.g., In re Marhoefer Packing Co., Inc., 674 F.2d 1139 (7th Cir. 1982); In re Hardy, 146 B.R. 206 (Bankr. N.D. Ill. 1993); In re Triple B Oil Producers, Inc., 75 B.R. 461 (Bankr. S.D. Ill. 1987). However, the Marhoefer court also held that "where the lessee has the right to terminate the transaction, it is not a conditional sale." In re

Marhoefer, 674 F.2d at 1143. In a footnote, the court explained:

[A] lease which provides for a certain rent in installments is not a conditional sale if the buyer can terminate the transaction at any time by returning the property, even though the lease also provides that if rent is paid for a certain period, the lessee shall thereupon become the owner of the property.

Id. n.3. This holding was reaffirmed in In re Powers, 983 F.2d 88 (7th Cir. 1993) where the lessee could likewise terminate the agreements in question at any time. The Powers court concluded that "even though the lessee can acquire the goods at the end of the lease's term, the lessee is under no obligation to make the payments that will allow him to exercise the option." Id. at 91. Similarly, in the present case, the inclusion of an option to purchase the warehouse for nominal consideration does not indicate that the lease is a security agreement where the lessee also has the right to terminate the lease at any time with no further obligation to the lessor.³

This conclusion, however, does not the end the Court's inquiry. The Court must also evaluate the remainder of the agreement to determine whether it is a true lease or a security agreement. Two other primary factors the courts have considered in

³ In addition, there is some question as to whether the option price in this case is nominal. If the option is exercised at the end of the lease, the warehouse is essentially free. If, however, the option is exercised at the end of twelve months, the earliest time possible under the express terms of the lease, the lessee would have to pay approximately \$996.69, more than fifty percent of the fair market value of the warehouse. (In an affidavit attached to Cook's brief, Michael Miller, an officer of Cook Sales, Inc., states that the fair market value of the warehouse is approximately \$1495.00. Debtors have submitted no evidence to indicate otherwise.) The Seventh Circuit has already held that an option price amounting to fifty percent of the property's fair market value is not nominal. In re Marhoefer, 674 F.2d at 1144.

making this determination are (1) whether the useful life of the property exceeds the length of the term of the lease, and (2) whether the amount of rent exceeds the fair market value of the property. See In re Marhoefer, 674 F.2d at 1145.

When the useful life of the property exceeds the term of the lease, the transaction is in effect a true lease. Id. See also 1D Secured Transactions Under U.C.C. § 30.02[4][c][vii] at 30-74. As explained by the court in Marhoefer:

An essential characteristic of a true lease is that there be something of value to return to the lessor after the term. Where the term of the lease is substantially equal to the life of the leased property such that there will be nothing of value to return at the end of the lease, the transaction is in essence a sale.

In re Marhoefer, 674 F.2d at 1145 (citations omitted).⁴ In the present case, Cook submitted an affidavit which states that "[t]he portable warehouse leased to Ms. McHughs, as well as the other models

⁴This test is often expressed in terms of "residual value." In other words, there must be something of value to return to the lessor at the expiration of the lease. If not, "the transaction functions exactly the same as an installment sale ... and whether there are any tangible remains to return to the lessor should be irrelevant." 1D Secured Transactions Under U.C.C. at 30-74.

This principle is now codified in section 1-201(37) of the Uniform Commercial Code. Specifically, the second paragraph of that section provides that a transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee; and

(a) the original term of the lease is equal to or greater than the remaining economic life of the goods.

810 ILCS 5/1-201(37)(a) (emphasis added).

manufactured by Cook Sales, Inc., maintains its value for a long period of time beyond the term of the lease," and "[t]he Lofted Barn model portable warehouse leased to Ms. McHugh reasonably may be expected to last for 25 to 35 years beyond the 36-month term of the McHugh lease." See Affidavit of Proof in Support of Objections to Amended Chapter 13 Plan, ¶¶ 10 & 11. Debtors have submitted no evidence to the contrary. Consideration of this factor, therefore, suggests that the transaction in question is a true lease.

With regard to the second factor -- whether the amount of rent exceeds the fair market value of the property -- the courts have held that "[i]f the total rentals payable under the lease equal or exceed the purchase price, then a security agreement is indicated." 1D Secured Transactions Under U.C.C. § 30.02[4][c][v] at 30-66.⁵ However, this test has been sharply curtailed by the amendments to section 1-201(37). Specifically, subparagraph (a) of the third paragraph provides:

A transaction does not create a security interest merely because it provides that:

(a) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or greater than the fair market value of the goods at the time the lease is entered into....

810 ILCS 5/1-201(37)(a). Therefore, it can no longer be assumed that

⁵The idea is that if the lessee is paying as much as it would cost to buy the property, the lessee is probably the owner and thus the lease is a security agreement." Id. at 30-66 & 30-77. "Conversely, when the lessee is obligated to pay a sum substantially less than the purchase price, a true lease is more likely." Id. at 30-77.

because the rental payments equal or exceed the purchase price, the transaction is necessarily a security agreement. Moreover, in the present case, the rent may or may not exceed the purchase price of \$1495.00, and this factor is therefore not determinative of the issue in this case. That is, if debtors exercise the option to purchase at the end of twelve months, they will, at that point, have paid \$830.52 in rent (excluding sales tax), an amount obviously less than the purchase price of the warehouse. If, however, debtors exercise the option to purchase at the end of the lease, they will have paid \$2491.56 in rent, an amount substantially more than the purchase price. In light of these facts and in view of the amendment to section 1-201(37), the Court does not believe that a security agreement exists merely because the rental payments do, at a certain point, exceed the purchase price.

Debtors urge the Court to find that the transaction creates a security interest because, pursuant to the terms of the agreement, debtors are responsible for the payment of sales tax and for the payment of insurance covering loss to the property. Again, the amendments to section 1-201(37) are relevant. Subparagraph (b) of the third paragraph provides:

A transaction does not create a security interest merely because it provides that:

(b) the lessee assumes risk of loss of the goods, or agrees to pay taxes, insurance, filing, recording, or registration fees, or service or maintenance costs with respect to the goods....

810 ILCS 5/1-201(37)(b). Therefore, "these terms are not sufficient per se to create a security interest." In re Lerch, 147 B.R. at 461. As

explained by the Marhoefer court, "[c]osts such as taxes, insurance and repairs are necessarily borne by one party or the other. They reflect less the true character of the transaction than the strength of the parties' respective bargaining positions." In re Marhoefer, 674 F.2d at 1146. See also In re Triple B Oil Producers, Inc., 75 B.R. at 465 (such matters are less persuasive as they are essentially matters of contract negotiation).

Accordingly, for the reasons stated, the Court finds that the agreement in question is a true lease. The objection to confirmation filed by Cook Sales, Inc. is sustained.

DATED: October 4, 1994