

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS**

IN RE:)	
)	
MORREL CLARK HICKS,)	Case No. 00-10825
)	Chapter 7
)	
Debtor.)	
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)	
J. MICHAEL MORRIS, Trustee,)	
)	
Plaintiff,)	
)	
v.)	Adversary No. 00-5126
)	
ERVIN LEASING COMPANY,)	
)	
)	
)	
Defendant.)	
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**MEMORANDUM OPINION ON MOTIONS
FOR SUMMARY JUDGMENT AND TO ASSUME OR REJECT LEASE**

This matter comes before the Court on the Chapter 7 trustee’s motion for summary judgment on his complaint to avoid an allegedly unperfected security interest and on Ervin Leasing’s a cross-motion for summary judgment. Because the determination of the summary judgment motions will dictate the result of Ervin’s motion for assumption or rejection of the lease, the Court considers that matter as well. At issue is whether the debtor’s lease of an Ameri-Cure Spraybooth Model SDD/AM 25149, SN # 34117 is a indeed true lease or instead creates a security interest. Ervin Leasing contends that the lease is in fact a true lease because the lease contract allows for early termination of the lease, the term of the lease is not greater than the

Spraybooth's remaining economic life, and the option purchase price at the end of the lease is not nominal. The trustee argues that the lease is in fact a disguised security interest because the lease contract meets the "bright line test" contained in Kan. Stat. Ann § 84-1-201(37) for security interests, namely that the lease is not terminable by the debtor and the debtor can purchase the Spraybooth at the end of the lease for "nominal" consideration. After careful review of the record, the Court concludes that the lease is in fact a disguised security agreement and that Ervin Leasing's security interest is not properly perfected. The trustee's motion for summary judgment is GRANTED and Ervin Leasing's motions for summary judgment and to require the trustee to assume or reject the lease are DENIED.

UNCONTROVERTED FACTS

On May 4, 1998, the debtor entered into a contract with Ervin Leasing to lease a Ameri-Cure Spraybooth Model SDD/AM 25149, SN# 34117, and signed an option to purchase the equipment at the end of the contract term for \$1,999.50. In the alternative, the debtor could renew the contract upon expiration of the contract period. The contract states that Ervin Leasing holds title to the equipment. Incident to the lease, Ervin Leasing purchased the Ameri-Cure equipment for shipment to the debtor.

On June 3, 1998, Ervin Leasing filed a financing statement with the Secretary of State showing the debtor's name as "Mac's Bodyshop." The name of "Morrell Clark Hicks" or a derivative thereof does not appear in the debtor's box on the financing statement. On March 15, 2000, debtor filed for Chapter 7 relief. The equipment was sold post-petition for \$6,354.00, including \$354.00 in sales tax and Ervin Leasing holds the proceeds.

JURISDICTION

This Court has jurisdiction over the matter. See 28 U.S.C. § 157(b)(2)(K) and (O). This is a core proceeding. See 28 U.S.C. § 1334.

ANALYSIS

Rule 56 of the Federal Rules of Civil Procedure governs summary judgment and is made applicable to adversary proceedings by Rule 7056 of the Federal Rules of Bankruptcy Procedure. In articulating the standard of review for summary judgment motions, Rule 56 provides that judgment shall be rendered if all pleadings, depositions, answers to interrogatories, and admissions and affidavits on file show that there are no genuine issues of any material fact and the moving party is entitled to judgment as a matter of law. Fed. R. Civ. P. 56(c); Fed. R. Bankr. P. 7056. In determining whether any genuine issues of material fact exist, the Court must construe the record liberally in favor of the party opposing the summary judgment. McKibben v. Chubb, 840 F.2d 1525, 1528 (10th Cir. 1988) (citation omitted). An issue is “genuine” if sufficient evidence exists on each side “so that a rational trier of fact could resolve the issue either way” and “[a]n issue is ‘material’ if under the substantive law it is essential to the proper disposition of the claim.” Adler v. Wal-Mart Stores, Inc., 144 F.3d 664, 670 (10th Cir. 1998). In this case, the facts are undisputed as to the language contained in the lease agreements and supplements and there are no other genuine issues of material fact. Therefore, the Court must decide whether either party is entitled to judgment as a matter of law.

To determine whether the lease is a true lease or a disguised security agreement, the Court must first analyze whether the agreement actually creates a security interest under the Uniform Commercial Code, § 1-201(37), as enacted in Kansas. Whether the transaction in question creates a security interest is resolved by reference to state law. In re Barton Indus., Inc., 104 F.3d 1241, 1247 n.2 (10th Cir. 1997)(citing Octagon Gas Systems, Inc. v. Rimmer (In re Meridian Reserve,

Inc.), 995 F.2d 948, 953-57 (10th Cir. 1993); Butner v. United States, 440 U.S. 48, 54-55

(1979)(the existence, nature and extent of a security interest in property is governed by state law).

Therefore, the Court will apply Kansas law, Kan. Stat. Ann. § 84-1-201(37), to determine the true nature of the agreement.

U.C.C. §1-201(37) is the “road sign that directs one to Article 9 for transactions that are really security transactions, or to Article 2A for transactions that are truly leases.” 2 White and Summers, Uniform Commercial Code, § 13-2 at p. 3 (4th ed. 1995 & Supp. 2001). The revised Kan. Stat. Ann. § 84-1-201(37), as adopted in Kansas in 1991, now defines the term “security interest” as follows:

(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 the 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. (Emphasis added).

Paragraph 2 of § 1-201(37) sets out a two-part test for determining whether a transaction should be considered a disguised security interest. Most courts interpreting the statute have found that while “the Court is to examine the facts of each case in characterizing the transaction . . . the first paragraph of the amended statute qualifies this by setting out a bright line test whereby, as a matter of law, a transaction creates a security interest.” In re Owen, 221 B.R. 56, 60 (Bankr. N. D. N.Y. 1998); In re Kim, 232 B.R. 324, 330 (Bankr. E. D. Pa. 1999). See also In re Southern Star Foods, Inc., 202 B.R. 784, 788 (Bankr. E. D. Okla. 1996)(The Court determined that a lease was a secured transaction “as a matter of law” because it met two-part test.) “If a Court determines that the consideration of this exception does not compel a conclusion that a security interest was created *per se*, it should proceed to an examination of all of the facts to determine whether the economic realities of a particular transaction create a security interest.” In re Triplex Marine Maint., Inc., 258 B.R. 659, 669 (Bankr. E. D. Tex. 2000). The intent of the parties is no longer a primary consideration in this determination, nor is the label of the document. Id. at 666, 668-69 (“[T]he jurisprudence is clear that, in determining whether a document is a true lease or a disguised security agreement, this court is not bound by any ‘acknowledgment’ by the Debtor nor by any other language or designation of parties contained in the agreement”)(citations omitted). Because the Kansas has adopted the official version of U.C.C. § 1-201(37), this Court is guided by decisions from other jurisdictions which interpret this uniform statute. See Kansas Comment to § 84-1-201(37) (1996); In re Murray, 191 B.R. 309, 314 (Bankr. E. D. Pa. 1996)(interpreting Pennsylvania law).

In this case, the leases meet the bright line test and are security interests as a matter of

law.¹ The Court first notes while Ervin Leasing is correct that the agreement allows for the debtor to terminate the lease, this provision is economically harsh and unreasonable, effectively rendering it meaningless. If debtor chooses to end the lease before the initial 60-month term expires, debtor is extensively penalized. Section 4 of the contract states that the initial term of the lease continues unless earlier cancelled pursuant to Section 20. Section 20 outlines what events constitute “default” under the contract, and Section 21 provides the remedies for such defaults. Section 21 states,

REMEDIES UPON DEFAULT. As of the date of occurrence of an Event of Default, there shall be immediately due and payable to the Lessor an amount (the Lessor’s Loss”) equal to the sum of the following: (a) the sum of all installments of the Base Rent, and other amounts payable by the Lessee hereunder which are at such time accrued but unpaid, plus (b) the sum of all installments of Base Rent for the remainder of the Initial Term of this Lease which are not accrued as of such date, discounted from the respective payments dates at the rate of five percent (5%) per annum, plus (c) if applicable, the amount of any tax credit required to be recaptured by the Lessor as a result of the early disposition of the equipment, plus (d) the amount equal to fifteen percent (15%) of the Lessor’s actual cost for the Equipment, plus (d) all applicable late charges and interest payable pursuant to Section 19, plus (f) all expenses (including reasonable attorney’s fees or fees from a collection agency) incurred by the Lessor in exercising any of the rights and remedies under this Lease.

Considering these provisions, it is apparent that debtor’s “right to terminate” the lease is fraught with economic peril. If debtor terminates the lease early, he remains liable for all 60 lease payments, plus reimbursement to Ervin of any tax credit recapture, 15 percent of the equipment’s cost, all late fees and all attorneys fees. Because these termination provisions are one-sided at

¹Because the Court finds that the lease is a security interest as a matter of law, the Court need not examine the individual facts of the case to determine the economic realities of the contract.

best and so penalize an early-terminating lessee, they render the lease effectively noncancellable and the first test under Kan. Stat. Ann. § 84-1-201(37) is met.

As for the four “bright line” factors, the fourth factor – the option to purchase for nominal additional consideration – can be properly applied under the evidence of this case. The fourth factor requires that the lessee have an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement. See Kan. Stat. Ann. § 84-1-201(37). Subsection (a) of the third paragraph of Kan. Stat. Ann. § 84-1-201(37) provides that “[a]dditional consideration is nominal if it is less than the lessee’s reasonably predictable cost of performing under the lease agreement if the option is not exercised.” Ervin Leasing argues that the \$1,999.95 option purchase price is not “nominal” but is “the parties best guess of the fair market value of the equipment, at the end of the lease.” However, Ervin Leasing does not provide the Court with any evidence as to what the fair market value of the Spraybooth would be at the end of the lease, and the Purchase Option itself does not state how the \$1,999.50 amount was agreed upon.

The Court concludes that debtor’s purchase price is nominal under the lease contract. First, should the lessee hold over, the lease is extended on a *year to year* basis, costing the debtor \$473.83 per month or \$5,685.96 for a year. Second, a debtor exercising his option to purchase will have paid at the end of the 60 month base term some \$29,000 in rents for the use of the booth, making it unlikely that the debtor is will walk away from the booth at the term’s end when he can pay only \$1,995 to retain the booth. While percentage tests are no longer determinative, they remain helpful in gaging the “nominal-ness” of the option price. Here, the option purchase price, \$1,999.50 is 10% of the original purchase price of \$19,995.00. To determine whether an option price represents nominal consideration, it can be compared to the total rental price of the

equipment, Orix Credit Alliance, Inc. v. Pappas, 946 F.2d 1258, 1261 (7th Cir. 1991), or the original purchase price of the leased property, In the Matter of Super Feeders, Inc., 236 B.R. 267, 270 (Bankr. D. Neb. 1999). In Orix, the Circuit found that an option price of 12% of the total rental payments was nominal consideration. 946 F.2d at 1261-62. In Super Feeders, the court held that a fixed purchase price of 5% of the original purchase price indicates nominal additional consideration. 236 B.R. at 270. Additionally, in Matter of Fashion Optical, 653 F.2d at 1389, a case decided before Article 2A was adopted and U.C.C. 1-201(37) amended, the Tenth Circuit held that the intent of the parties to create a security interest was evident when the option purchase price was less than 25% of the original purchase price. When compared to the \$29,000 total rents due under the lease or the annual holdover rentals of \$5,685.96, the \$1,995 option price is indeed nominal. The agreement upon which Ervin bases its claim created a security interest, not a true lease.

Ervin Leasing's security interest in the debtor's Spraybooth is not properly perfected. In this case, the provisions of "old" U.C.C. Article 9 apply.² See Kan. Stat. Ann. § 84-9-102. Ervin Leasing is required to have a perfected security interest in the equipment in order to prevail over the trustee as a lien creditor under Kan. Stat. Ann. § 84-9-301 and 11 U.S.C. § 544(a). However, Ervin Leasing is not properly perfected, and concedes such point. Ervin Leasing's filing the financing statement under the individual debtor's trade name, "Mac's Bodyshop," rather than debtor's real name, renders it seriously misleading. See Kan. Stat. Ann. § 84-9-402(7) and Pearson v. Salina Coffeehouse, Inc., 831 F.2d 1531 (10th Cir. 1987). Ervin Leasing's security interest is not properly perfected, See Kan. Stat. Ann. § 84-9-402(8), and the trustee may avoid it

²Because this case was filed before July 1, 2001, the effective date of the revised Article 9, the "old" Article 9 perfection rules apply. See Kan. Stat. Ann. § 84-9-705(b).

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In re: Morrel Clark Hicks; Case No. 00-10825-7; Adv. Case No. 00-5126; **Memorandum Opinion on Motions
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using his hypothetical lien creditor powers granted by 11 U.S.C. § 544(a).

Finally, because Ervin's agreement is not a lease, Ervin Leasing is not entitled to an order requiring the trustee to assume or reject an unexpired lease under 11 U.S.C. § 365.

Based on the foregoing analysis, the Court finds that the lease contract between debtor and Ervin Leasing Company is in fact a disguised security agreement as a matter of law. The Court also finds that Ervin Leasing Company's security interest is not properly perfected as to the Ameri-Cure Spraybooth Model SDD/AM 25149, SN # 34117 and that the trustee may avoid Ervin Leasing Company's lien in same. Ervin Leasing Company's motion to require assumption or rejection of the lease under 11 U.S.C. § 365 is DENIED and judgment will entered for the trustee requiring Ervin Leasing Company to turn over to the trustee forthwith the \$6,354.00 in sale proceeds in its possession plus any interest accrued thereon. A Judgment on Decision will issue this day.

IT IS SO ORDERED.

Dated this 22nd day of April, 2002.

ROBERT E. NUGENT, BANKRUPTCY JUDGE
UNITED STATES BANKRUPTCY COURT

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DISTRICT OF KANSAS

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In re: Morrel Clark Hicks; Case No. 00-10825-7; Adv. Case No. 00-5126; **Memorandum Opinion on Motions
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CERTIFICATE OF SERVICE

The undersigned certifies that copies of the **Memorandum and Opinion** were deposited in the United States mail, postage prepaid on this 22nd day of April, 2002, to the following:

J. Michael Morris
1600 Epic Center
301 N. Main
Wichita, KS 67202

Eric D. Bruce
Bruce, Bruce & Holt, L.L.C.
439 North McLean, Suite 100
P.O. Box 75037
Wichita, KS 67275

William J. Stapleton
126 S. Main Street
Ann Arbor, MI 48104

U.S. Trustee
500 Epic Center
301 N. Main
Wichita, KS 67202

Morrel Clark Hicks
424 Oil Hill Rd.
El Dorado, KS 67042

William H. Zimmerman
Case, Moses, Zimmerman & Wilson, P.A.
400 Commerce Bank Center
150 N. Main
Wichita, KS 67202-1321

Janet Swonger,
Judicial Assistant

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