

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

IN RE:)	
)	
CHANCE INDUSTRIES, INC.,)	Case No. 01-11698
)	Chapter 11
Debtor.)	
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)	
CHANCE INDUSTRIES, INC.)	
)	
Plaintiff,)	
)	
v.)	Adversary No. 01-5132
)	
TCF LEASING, INC. and)	
BANK OF BLUE VALLEY,)	
)	
Defendants.)	
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MEMORANDUM AND OPINION

This matter comes before the Court on the Bank of Blue Valley’s motion for summary judgment and the debtor’s objection thereto and counter-motion for summary judgment. The issue before the Court is whether four leases of what is referred to as “technology equipment” and computer software are true leases or disguised security agreements. The Bank of Blue Valley (the “Bank”) contends that the leases are in fact true leases because the agreement expressly states that the transactions are leases and debtor has the opportunity to purchase the equipment at the end of the lease for fair market value. Debtor argues that the leases are in fact disguised security agreements because the lease agreements meet the requirements set forth in Kan. Stat. Ann. § 84-1-

201(37) for security interests, namely that the leases are not terminable by the debtor and the debtor can purchase the equipment at the end of the lease for “nominal” consideration. After careful review of the record, the Court concludes that the leases are in fact disguised security agreements. The plaintiff’s motion for summary judgment is GRANTED and the defendant’s summary judgment motion is DENIED.

UNCONTROVERTED FACTS

At issue are four leases between Security Leasing Services, Inc. (“Security Leasing”) and Chance for technology equipment and computer equipment and services. The leases were assigned to the Bank who is the defendant in this action. On September 23, 1998, Chance entered into Lease No. 9079580 and Supplement to Equipment Lease Agreement (the “First Lease”) with Security Leasing for the lease of certain technology equipment, software and services. Under the First Lease, Chance was to make monthly lease payments of \$17,129.88 for 36 months, for a total of \$616,675.68. The original purchase price of the equipment was \$504,557.68. Security Leasing assigned all of its rights, title and interest in and to the First Lease to the Bank of Blue Valley, and the Bank perfected its interest in the collateral by filing a UCC-1 Financing Statement with the Kansas Secretary of State on October 15, 1998. Paragraph 1 of the Supplemental Lease Agreement to the First Lease provides that Chance, at its option, “may purchase all of the Lessor’s (Bank’s) right, title and interest in and to all, but not less than all, of the equipment . . . for a purchase price of \$15,700.00 which the lessor estimates to be the fair market value of the equipment.” Paragraph 2 of the Supplement states that “the ‘fair market value’ of the Equipment shall be determined by an independent third-party appraiser selected by Lessee (Chance).” However, if Chance chooses not to purchase the equipment for any reason, the lease term is “*automatically and without further action on the part of Lessor or Lessee*” extended for an

additional term of twelve (12) months at a monthly rental of \$10,500.00 . . .” (Italics added). Further, the lease states, “THIS LEASE IS NOT CANCELABLE OR TERMINABLE BY LESSEE,” although the Supplement provides that “[L]essee may terminate this lease during the 12th month of the original term provided that Lessee notifies Lessor, in writing, at least 180 days prior to such termination or cancellation. In order to terminate this Lease, Lessee shall be obligated to pay an early termination fee equal to 56.00% of the Equipment cost (\$290,000.00). . .” Neither the lease nor the supplement provide for Chance’s termination at any other time during the lease. As of the date Chance filed its Chapter 11 petition, Chance had defaulted on the lease, not making any payments since February 2001, yet still has possession of and continues to use the equipment. Were the Court to find the lease a true lease, Chance would owe the Bank \$118,479.82 in lease payments from the petition date to the end of the lease.

Chance also entered into three (3) additional leases similar to the First Lease with Security Leasing. The language in the leases and supplements are the same, with differences made only to account for the price of the equipment. On December 16, 1998, Chance entered into Lease No. 9082565 (the “Second Lease”) for the lease of certain technology equipment and consulting services provided by Grant Thornton. Under the Second Lease, Chance was to make monthly lease payments of \$2,282.55 for 36 months, for a total of \$82,171.80. Security Leasing assigned all of its rights, title and interest in and to the Second Lease to the Bank, and Bank perfected its security interest in the equipment on December 28, 1998. The Second Lease’s supplement provides that Chance can purchase the equipment “for a purchase price equal to the lesser of the then fair market value of the Equipment determined as hereinafter provided or \$2,100.00.” The “fair market value” of the equipment is to be determined by an independent third-party appraiser selected by Chance. If Chance chooses not to purchase the equipment at the end of the lease, the

lease automatically extends for an additional 12 months at a monthly rental of \$300.00. Again, the lease is not terminable, although the supplement provides that Chance may terminate the lease during the 12th month of the original term, but is obligated to pay an early termination fee equal to 56.00% of the Equipment cost – \$38,734.00. Neither the lease nor the supplement provides for Chance’s termination at any other time during the lease. Prior to filing its petition, Chance defaulted on the lease and has not made any lease payments since February 2001. Were the Court to construe the lease as a true lease, Chance would owe the Bank \$22,642.95 in lease payments from the petition date to the end of the lease.

On February 1, 1999, Chance entered into Lease No. 9084568 (the “Third Lease”) with Security Leasing for the lease of technology equipment and consulting services with lease payments of \$626.34 per month for 36 months, for a total of \$22,548.24. Security Leasing assigned all of its rights, title and interest in and to the Third Lease to the Bank, and the Bank perfected its interest in the equipment on February 9, 1999. The Third Lease provides that at the end of the lease, Chance can purchase the equipment for a price equal to the lesser of the then fair market value of the equipment or \$600.00. The “fair market value” of the equipment is determined by an independent third-party appraiser selected by Chance. If Chance chooses not to purchase the equipment, the lease automatically continues for 12 months at a monthly rental of \$85.00. Again, the lease provides that it is not cancelable or terminable, but the supplement provides that Chance can terminate the lease during the 12th month, but is obligated to pay 56.00% of the equipment cost – \$10,628.81. Neither the lease nor the supplement provides for Chance’s termination at any other time during the lease. Prior to filing its petition, Chance defaulted on the lease and has not made any lease payments since February 2001. Were the Court to construe the lease as a true lease, Chance would owe the Bank \$6,863.40 in lease payments from the petition

date to the end of the lease.

Finally, on April 21, 1999, Chance entered into Lease No. 9094113 (the “Fourth Lease”) with Security Leasing for the lease of technology equipment and Chance was to make monthly payment of \$3,028.50 for 36 months, for a total of \$109,026.00. Security Leasing assigned all of its rights, title and interest in and to the Fourth Lease to the Bank, and the Bank perfected its lien on June 9, 1999. The Fourth Lease provides that Chance can purchase the equipment for \$2,950.00, which the Bank estimates to be the then fair market value, however the value is determined by an independent third-party appraiser selected by Chance. If Chance chooses not to purchase the equipment, the lease automatically continues for 12 months at a monthly rental of \$297.50. Again, the lease provides that it is not cancelable or terminable, but the supplement provides that Chance can terminate the lease during the 12th month, but is obligated to pay 56.00% of the equipment cost – \$50,929.81. Neither the lease nor the supplement provides for Chance’s termination at any other time during the lease. Prior to filing its petition, Chance defaulted on the lease and has not made any lease payments since February 2001. Were the Court to construe the lease as a true lease, Chance would owe the Bank \$42,865.85 in lease payments from the petition date to the end of the lease.

JURISDICTION

This Court has jurisdiction over the matter. See 28 U.S.C. § 157 (b)(2)(K), (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. Rule 56, in articulating the standard of review for summary judgment motions, 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. Security interest issues raised in bankruptcy case are 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. (Italics 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 statute is based on U.C.C. § 1-201(37), this Court is guided by decisions from other jurisdictions which interpret this uniform statute and Kansas follows the reasoning set forth by these courts. 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 that Chance is essentially precluded from terminating the leases. Each lease states that it is not cancelable or terminable by the lessee. Although, as the Bank correctly points out, the supplements to the leases allow for the lessee to terminate the lease, this provision is very limited and economically harsh and unreasonable, effectively rendering it meaningless.

¹Because the Court find that the leases are security interests as a matter of law, the Court need not examine the individual facts of the case to determine the economic realities of the agreements.

The supplement allows the Chance to terminate the lease *only* in the 12th month, and *only* with 180 days notice to lessor. *At no other time is Chance allowed to terminate the lease.* Furthermore, if Chance terminates the lease, it is extensively penalized. Not only is Chance obligated to pay for 12 months' rental, it must also pay lessor an early termination fee equal to 56% of the equipment cost. For example, in the First Lease, if Chance were to terminate the lease, Chance would owe the Bank $\$17,129.88 \times 12 \text{ months} = \$205,558.56$ (rental fees) + $\$290,000$ (early termination fee), for a total of $\$495,558.56$. The equipment's original purchase price is $\$504,557.68$.² Therefore, if Chance terminates the lease early, it essentially pays lessor the entire value of the equipment. The cancellation provisions in the remaining three leases are equally unreasonable.³ Because these termination provisions are excessively unfair and no lessee in its right mind would prematurely terminate the lease, the leases are effectively noncancelable 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

²See Plaintiff's (1) Objection to Motion of Defendant Bank of Blue Valley for Summary Judgment, and (2) Counter Motion for Summary Judgment, Exhibit 2.

³Under the Second Lease, if Chance were to terminate the lease early, it would owe the Bank $\$2,282.55 \text{ rent} \times 12 \text{ months} = \$27,390.60 + \$38,734.00$ (early termination fee), for a total of $\$66,124.60$. The equipment's original purchase price was $\$66,213.80$.

Under the Third Lease, if Chance were to terminate the lease early, it would owe the Bank $\$626.34 \text{ rent} \times 12 \text{ months} = \$7,516.08 + \$10,628.81$ (early termination fee), for a total of $\$18,144.89$. The equipment's original purchase price was $\$21,579.87$.

Under the Fourth Lease, if Chance were to terminate the lease early, it would owe the Bank $\$3,028.50 \text{ rent} \times 12 \text{ months} = \$36,342.00 + \$50,929.81$ (early termination fee), for a total of $\$87,271.81$. The equipment's original purchase price was $\$90,490.60$.

Kan. Stat. Ann. § 84-1-201(37). The Bank argues that because each lease provides the option to purchase for fair market value, the additional consideration is not nominal.

“Under § 1-201(37), the most significant factor that indicates a disguised security agreement, not a true lease, is where the option price to purchase the leased equipment at the end of the lease term is nominal. If the lease agreement explicitly provides that the lessee has an option to purchase the leased goods for nominal consideration, the agreement is presumed to be a disguised security agreement. (Citations omitted.) On the other hand, if the lessee can exercise the option only by paying the fair market value of the property at the conclusion of the lease term an inference is created that the option price is not nominal. (Citations omitted.) ‘That inference, however, can be rebutted if the fair market value of the property is shown to be negligible.’” (Citations omitted.)

In re Edison Bros. Stores, Inc., 207 B.R. 801, 810 (Bankr. D. Del. 1997). Under the First and Fourth Leases, Chance is given the option to purchase the equipment for a stated price – \$15,700 and \$2,950, respectively – which lessor estimates to be the fair market value of the equipment. The Supplement provides that an independent third-party appraiser may appraise the equipment for the purposes of determining fair market value, however, the appraisal process is meaningless since it does not state if the fair market value is determined to be higher or lower than the stated purchase price, that Chance may purchase for the appraised fair market value instead. In the Second and Third Leases, Chance is given the option of purchasing the equipment for a purchase price equal to the lesser of the then fair market value of the equipment as determined by the appraiser, or \$2,100 and \$600, respectively.

The Court is not convinced that “the inclusion of a potential reference to fair market value in the determination of the purchase option amount precludes any examination of the nominality of the purchase option under [1-201(37)].” Triplex Marine, 258 B.R. at 671.

“Courts have recognized that an apparent option to purchase, even when potentially based upon fair market value, can, in fact, be illusory under the circumstances of a particular case. Articulated as

a ‘sensible person’ test, it provides that ‘where the terms of the lease and option to purchase are such the only sensible course for the lessee at the end of the lease term is to exercise the option and become the owner of the goods, the lease was intended to create a security interest.’ Steele v. Gebetsberger (Matter of Fashion Optical, Ltd.), 653 F.2d 1385, 1389 (10th Cir. 1981).”

Triplex Marine, 258 B.R. at 671. It has also been stated, “if only a fool would fail to exercise the purchase option, the option is generally considered nominal and the transaction characterized as a disguised security agreement.” In re Taylor, 209 B.R. 482, 486 (Bankr. S. D. Ill. 1997), *as cited in* Triplex Marine, at 671. See also In the Matter of Fashion Optical, 653 F.2d at 1389.

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. While these percentages are not determinative of whether a lease is a security agreement, they are a useful guideline in deciding if the purchase price is nominal.

Under either formula, Chance’s purchase price under all four leases is nominal. The First Lease’s option purchase price of \$15,700 is 2.55% of the total lease payments of \$616,675.08; the Second Lease’s option purchase price of \$2,100 is 2.55% of the total lease payments of \$82,171.88; the Third Lease’s option purchase price of \$600 is 2.66% of the total lease payments

of \$22,548.24; and the Fourth Lease's option purchase price of \$2,950 is 2.7% of the total lease payments of \$109,026. These figures are undoubtedly nominal compared with the cost of renting the equipment for another 12 months as Chance is **required** to do under the supplement if it does not purchase the equipment after 36 months. Under Kan. Stat. Ann. § 84-1-201(37), "[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." For instance, the First Lease requires Chance to continue leasing the equipment for 12 months at \$10,500/month if it does not purchase the equipment. This totals another \$126,000 in lease payments, compared to the option purchase price of \$15,700. Under the First Lease, the option purchase price is 3.11% of the original list price of the equipment, and the option purchase price is 3.17%, 2.7%, 3.3% of the original list price of the equipment in the other three leases respectively.⁴ Viewed in this light, the purchase price is nominal. Clearly, Chance is obligated to exercise its option to purchase the equipment as Chance would be a fool not to purchase.

Based on the foregoing conclusions, the Court FINDS that the lease agreements between Chance Industries, Inc. and the Bank of Blue Valley are in fact disguised security agreements as a matter of law. The Court ORDERS that the Bank of Blue Valley's Motion For Summary Judgment is DENIED and the Debtor's Counter Motion For Summary Judgment is GRANTED. A Judgment on Decision will issue this day.

Dated this 29th day of March, 2002.

⁴It would also be foolish for Chance not to exercise the purchase option in the remaining three leases. Under the Second Lease, Chance can purchase for \$2,100 or continue leasing for \$3,600; under the Third Lease, Chance can purchase for \$600 or continue leasing for \$1,020; under the Fourth Lease, Chance may purchase for \$2,950 or continue leasing for \$3,570.

ROBERT E. NUGENT, BANKRUPTCY JUDGE
UNITED STATES BANKRUPTCY COURT
DISTRICT OF KANSAS