

The relief described hereinbelow is **SO ORDERED**.

**SIGNED** this 17th day of October, 2023.



  
Robert D. Berger  
United States Bankruptcy Judge

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

In re:

**JIMMY JO LEE SOUTHWICK and  
EILEEN MARIE SOUTHWICK,**

Debtors.

Case No. 23-20804  
Chapter 13

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**ORDER SETTING MATTER FOR EVIDENTIARY HEARING**

Jimmy Southwick, one of the debtors in this jointly-filed Chapter 13 case, entered into a “Closed End Motor Vehicle Lease” with AE Rentals, Inc., of Lawrence for a 2014 Ford Mustang GT on April 24, 2023.<sup>1</sup> A few months later, Southwick and

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<sup>1</sup> See ECF 45-1 (the “Lease”).

his wife, Eileen, filed for bankruptcy. The Southwicks now ask the Court to recharacterize the Lease as a security interest under Kan. Stat. Ann. § 84-1-203.<sup>2</sup>

**A. Lease terms**

The terms of the Lease are, like many auto leases, analogous to those of a loan. The Lease begins with a “gross capitalized cost” of \$29,104.<sup>3</sup> The gross capitalized cost is reduced by Southwick’s net down payment of \$3,579.62<sup>4</sup> for an “adjusted capitalized cost” of \$25,524.38.<sup>5</sup> The adjusted capitalized cost is analogous to the principal amount of an auto loan.

Similar to an auto loan, where payments are allocated between principal and interest, payments under the Lease are allocated between depreciation and rent. “Depreciation” is analogous to a reduction in principal; it accrues over time as the Lease amortizes. Because the Mustang will have a “residual value” of \$4,999.80 at the end of the Lease term,<sup>6</sup> the total depreciation that will accrue under the Lease is \$25,524.38 minus \$4,999.80, or \$20,524.58.<sup>7</sup>

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<sup>2</sup> ECF 45. The Southwicks appear by attorney Kristina Crump. AE Rentals appears by attorney Patrick Barnes. This matter was submitted on the briefs and arguments of counsel at a September 19, 2023 hearing.

<sup>3</sup> See Lease § 3a. The \$29,104 represents \$24,999 for the Mustang, \$999 for an assignment/documentation fee, \$2,307 for a service contract, and \$799 for gap coverage. See *id.* § 5.

<sup>4</sup> Southwick actually made a down payment of \$3,900, but \$320.38 of that amount went to sales tax. See *id.* § 3.

<sup>5</sup> See *id.* § 3a.

<sup>6</sup> See *id.*

<sup>7</sup> See *id.*

Unlike an auto loan, which must disclose interest in terms of an annual percentage rate, an auto lease can disclose “rent,” which is analogous to interest, in terms of the total amount charged. (The percentage rate can be derived mathematically, but the Court need not do so to rule on the Southwicks’ motion.) Here, the Lease provides that the total amount charged for rent will be \$16,476.67.<sup>8</sup>

Because total depreciation is \$20,524.58 and total rent is \$16,476.67, the total “base” (i.e., pretax) amount paid by Southwick under the Lease will be \$37,001.25. That amount is divided into 117 biweekly payments. The base amount of each payment is therefore \$37,001.25 divided by 117, or \$316.25. Adding \$28.30 to each payment for sales tax yields 117 biweekly payments of \$344.55.<sup>9</sup>

In summary:

Gross capitalized cost	\$29,104
Capitalized cost reduction	\$3,579.62
Adjusted capitalized cost	\$25,524.38
Residual value	\$4,999.80
Depreciation	\$20,524.58
Rent	\$16,476.67
Total of base periodic payments	\$37,001.25
Number of payments	117
Base periodic payment	\$316.25
Periodic sales/use tax	\$28.30
Total periodic payment	\$344.55

N.b. 117 biweekly payments means  $117 \times 2 = 234$  weeks, or  $234 / 52 = 4.5$  years.

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<sup>8</sup> See Lease § 3a.

<sup>9</sup> See *id.*

At any given time during the Lease term, the “adjusted lease balance,” which is analogous to unpaid principal, is the adjusted capitalized cost minus accrued depreciation and the first base payment.<sup>10</sup> Payments are allocated between rent and depreciation by multiplying the adjusted lease balance, also known as the “balance subject to rent charge,” by the “constant rate implicit in the Lease” (which can be derived mathematically, *see supra*).<sup>11</sup> If the constant rate implicit in the Lease is  $r$ , then out of any given \$316.25 base payment,  $r$  times (\$25,524.38 minus accrued depreciation minus \$316.25) is allocated to rent; the remainder of the \$316.25 is allocated to depreciation.

Over time, as depreciation accrues, the adjusted lease balance decreases from \$25,524.38 down to \$4,999.80.<sup>12</sup> Southwick has the option to buy the Mustang for \$4,999.80 at the end of the Lease term.<sup>13</sup> If he does not exercise the purchase option, he must return the Mustang to AE Rentals.<sup>14</sup>

Southwick also has the option to buy the Mustang if he terminates the Lease early; in that case, the purchase price would be the adjusted lease balance (defined *supra*).<sup>15</sup> If Southwick terminates the Lease early but does not buy the Mustang, he

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<sup>10</sup> *See* Lease § 14. This implies that all of the first base payment is allocated to depreciation.

<sup>11</sup> *See id.*

<sup>12</sup> *See id.* § 3a (providing that \$4,999.80 residual value is used to calculate payment amount).

<sup>13</sup> *See id.*

<sup>14</sup> *See id.* § 15 (“Return of the Vehicle”).

<sup>15</sup> *See id.* (“Option to Purchase Vehicle Upon Early Termination”).

must pay a \$500 “early termination fee,” plus the adjusted lease balance, minus the Mustang’s “realized value at termination”<sup>16</sup>—unless the total of those amounts would be more than his remaining Lease payments, in which case he would only need to pay the total of the remaining payments.<sup>17</sup>

**B. Discussion**

Southwick argues that the Lease creates a security interest under Kan. Stat. Ann. § 84-1-203(b) and this Court’s holding in *In re James*, Case No. 12-23121, 2014 WL 5785316 (Bankr. D. Kan. Nov. 4, 2014). Section 84-1-203(b) provides:

A transaction in the form of a lease creates a security interest if the consideration that 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 and is not subject to termination by the lessee, and:

- (1) The original term of the lease is equal to or greater than the remaining economic life of the goods;
- (2) 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;
- (3) the lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or for nominal additional consideration upon compliance with the lease agreement; or
- (4) the lessee has an option to become the owner of the goods for no additional consideration or for nominal

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<sup>16</sup> The Lease defines “realized value at termination” as “the price we receive for the Vehicle at disposition; the highest offer we receive for disposition of the Vehicle; . . . the fair market value of the Vehicle at the end of the Lease term,” or, as determined by a professional appraiser, “the wholesale value of the Vehicle that could be realized at sale.” *See* Lease § 14.

<sup>17</sup> *See id.*

additional consideration upon compliance with the lease agreement.

The burden here is on the Southwicks to show that the Lease should be recharacterized as a security interest. *Cf. In re James*, 2014 WL 5785316, at \*4.

Here, Southwick's obligation to repay the adjusted capitalized cost of the Lease is not subject to termination. Thus, as in *In re James*, the first prong of § 84-1-203(b) is satisfied. *See id.*

The issue here is with the second prong of the test, which requires satisfaction of one of the four numbered elements of § 84-1-203(b). In *In re James*, this Court held that § 84-1-203(b)(4) was satisfied because the lessees could purchase their vehicle for "as little as \$200" by terminating the agreement just before their last payment was due. *In re James*, 2014 WL 5785316, at \*5; *see id.* (reasoning that \$200 was "nominal" compared to vehicle's estimated end-of-lease fair market value). But *In re James* is distinguishable, because in that case, the lessees' purchase price on early termination was capped at the total of their remaining lease payments. *See id.* Here, Southwick's early-termination *liability* is capped at that amount—if he returns the Mustang to AE Rentals. *See Lease* § 14. His early-termination *purchase price*, on the other hand, is the "adjusted lease balance." *See Lease* § 15. Because there is no evidence that the fair market value of the Mustang will exceed the adjusted lease balance at any point during the Lease, or that it will exceed \$4,999.80 at the end of the Lease term, there is no evidence that the Lease satisfies § 84-1-203(b)(4).

For those reasons, and because there is no evidence regarding the economic life of the Mustang,<sup>18</sup> two issues will be set for evidentiary hearing: (1) the expected end-of-Lease fair market value of the Mustang (if different from \$4,999.80) and (2) the remaining economic life of the Mustang. If the Southwicks do not present any evidence on those issues, the Court will deny their motion to recharacterize the Lease as a security interest, and will sustain AE Rentals' objection to confirmation,<sup>19</sup> without reaching any of the arguments raised by AE Rentals in its opposition to the Southwicks' motion.<sup>20</sup>

IT IS SO ORDERED.

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<sup>18</sup> "Remaining economic life" is a component of § 84-1-203(b)(1) through (3).

<sup>19</sup> ECF 53.

<sup>20</sup> ECF 55. AE Rentals' main argument is that if the Lease is a disguised security interest under Kan. Stat. Ann. § 84-1-203(b), the transaction would be "fraudulent and void" under Kan. Stat. Ann. § 8-135(c)(7), which provides:

The sale of a vehicle required to be registered under the laws of this state, without assignment of the certificate of title, is fraudulent and void, unless the parties shall agree that the certificate of title with assignment thereof shall pass between them at a time other than the time of delivery, but within 60 days thereof.

If the Southwicks do present evidence that the Lease satisfies one of the four numbered elements of § 84-1-203(b), AE Rentals should be prepared to argue two things: first, whether a lease agreement that does not purport to transfer title is a "sale" under § 8-135-(c)(7), *cf.* Kan. Stat. Ann. § 84-2-106 ("A 'sale' consists in the passing of title from the seller to the buyer for a price . . . ."), and second, whether a vehicle subject to § 8-135(c)(7) can also be the subject of a disguised security agreement under § 84-1-203.