IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF TEXAS
BEAUMONT DIVISION

U.S. BANKRUPTCY COURT
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EASTERN DISTRICT OF TX
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| IN RE: | § | |
| | § | |
| DALLAS HENRY | § | Case No. 02-12790 |
| | § | |
| | § | Chapter 13 |

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**MEMORANDUM OF DECISION**[1]

This matter is before the Court to consider the "Motion for Relief from Automatic Stay" (the "Motion") filed in the above-referenced case by Bank of America ("Bank") whereby the Bank is seeking modification of the automatic stay in order to gain possession of a 2001 Ford F-150 SuperCab pickup (the "Vehicle") which it purportedly leased to the Debtor, Dallas Henry ("Debtor"). Prior to addressing the Motion on its merits, the parties submitted to the Court a dispute which had arisen regarding the proper characterization of the Bank's claim. Pursuant to its documents, the Bank alleges that it owns the Vehicle, subject to a contractual agreement whereby it leased the Vehicle to the Debtor. However, the Debtor now claims that the transaction actually constituted a disguised sale of the Vehicle to the Debtor with the Bank retaining a perfected security interest in the Vehicle. Because the proper characterization of the Bank's claim and the relative property rights of the Debtor in the Vehicle is critical to the treatment of the Bank's claim in a Chapter 13 context, the parties submitted this initial dispute to the Court. Upon conclusion of the hearing on this matter, the Court took the matter under advisement. This memorandum of decision disposes of the sole issue presently pending before

[1]This Memorandum of Decision is not designated for publication and shall not be considered as precedent, except under the respective doctrines of claim preclusion, issue preclusion, the law of the case or as to other evidentiary doctrines applicable to the specific parties in this proceeding.

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the Court.[2]

## Factual Background

The Debtor, Dallas W. Henry, Jr. (the "Debtor") was interested in obtaining a new vehicle. Knowing precisely what type of vehicle he desired and with the intention of utilizing his 1999 Ford F-150 pickup as a trade-in, the Debtor shopped for a new vehicle on May 30, 2001, at Gillespie Ford, a Ford dealership in San Antonio, Texas. Upon locating from Gillespie's inventory a 2001 Ford F-150 SuperCab pickup truck (the "Vehicle") which he wished to acquire, the Debtor disclosed his desired monthly payment amount and explored with the dealership the "best way to finance" the acquisition of the desired vehicle. He was informed that the best means by which to acquire the vehicle on the financial terms he desired was through a vehicle leasing arrangement through Bank of America. The Debtor agreed to consummate the vehicle acquisition through that suggested means.

On May 30, 2001, the Debtor executed a "Motor Vehicle Lease Agreement - Closed End" for the acquisition of the Vehicle.[3] The Agreement executed by the parties is clearly denominated as a lease agreement for a sixty (60)-month period. It identifies Gillespie Ford as the initial Lessor and the Debtor executed the Agreement as a "Lessee."[4] It clarifies the amounts due and owing at its inception and the monthly financial obligations imposed upon the Debtor for

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[2] This Court has jurisdiction to consider the Motion pursuant to 28 U.S.C. §1334(b) and 28 U.S.C. §157(a). The Court has the authority to enter a final order in this contested matter since it constitutes a core proceeding as contemplated by 28 U.S.C. §157(b)(2)(A), (G) and (O).

[3] *See* Debtor's Exhibit 2.

[4] Though the initial lessor is the dealership, the agreement clearly contemplates the assignment of the lease to Bank of America. The agreement is documented on a Bank of America form and the Agreement contemplates the payment of a fee to the dealership for the "solicitation, procurement or production of this lease."

the term of the Agreement. It discloses all required financial data and sets the residual value of the Vehicle at the end of lease term at $11,608.35. Paragraph 9 of the Agreement gives the Debtor an option to purchase the Vehicle at the end of the stated lease term "for the Residual Value, plus the Purchase Option Fee of $150, plus any unpaid Monthly Payments, late charges or other fees, plus any official fees or taxes imposed in connection with the purchase." Paragraph 21 of the Agreement purportedly gives the Debtor the right to terminate the lease at any time, but subjects the Debtor to certain penalties for early termination, including full liability for the balance of all monthly payments which remained unpaid under the Agreement, plus additional amounts depending upon certain factors described in the Agreement. The Debtor acknowledged under ¶ 24 of the Agreement that "this is a true Lease and unless I exercise my Purchase Option I have no ownership interest in the Vehicle, or any of the component parts."[5] As a result of this transaction, the Texas Certificate of Title pertaining to the Vehicle identifies the previous owner as Gillespie Ford and the current owner of the Vehicle as Bank of America Auto Finance.[6]

However, some of the documentation provided to the Debtor for execution on the sales date was inconsistent with a leasing transaction. The Debtor was provided with a "Rider to Retail Installment Contract" under which the Vehicle and the Debtor's trade-in were identified

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[5] However, the 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. *In re Homeplace Stores, Inc.*, 228 B.R. 88, 93 (Bankr. D.Del. 1998)[noting that "[w]hether a document is a security agreement as opposed to a lease. . . is dependent on certain factors extrinsic to the document and not capable of control by words in the document,"] *(quoting* 2 JAMES J. WHITE AND ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 565 (4th ed. 1995 & Supp. 1998); *see also, In re Owen*, 221 B.R. 56, 62 (Bankr. N.D.N.Y. 1998)[finding that "the labeling of the Agreement as a 'lease' and referring to the parties as 'lessor' and 'lessee' in and of themselves are not controlling."].

[6] *See* Bank's Exhibit B.

by make, model and VIN, and the rider sets forth agreements regarding the credit application, the placement of financing, the procurement of insurance and other details which would allow the Debtor to take immediate possession of the Vehicle.[7] This rider specifically purports to be "attached to and made a part of a certain Retail Installment Sales Contract dated as set forth above, by and between Gillespie Ford, 'Seller,' and the 'Buyer' set forth above [identified as the Debtor], relating to the purchase of the vehicle described above." Yet the rider erroneously identifies a lien in favor of Ford Motor Credit Co. and a lien amount of $20,543.92, a figure which does not coincide with any of the financial figures provided in the Lease Agreement. The Debtor also submitted into evidence what appears to be a cover page of some type on Gillespie Ford letterhead which identifies the Debtor as the "registered owner," identifies the Vehicle as the "vehicle purchased," and identifies Bank of America as the "lienholder of lease"(sic).[8] The Debtor acknowledged at the hearing that he read all of this documentation prior to his execution of the documents and that he understood them.

## Discussion

The motivation of the Debtor to characterize this transaction as one creating a disguised security interest is not difficult to comprehend. As recognized in a leading article examining this area of jurisprudence in a bankruptcy context:

> A finding that the lease is a disguised financing would favor the debtor in that the equipment would be considered property of the debtor's estate. . . . [E]ven

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[7] *See* Debtor's Exhibit 3.

[8] *See* Debtor's Exhibit 1. The Debtor also executed a separate "Arbitration Provision" which references a "Motor Vehicle Retail Installment Sales Contract." *See* Debtor's Exhibit 4.

> if the debt (sic) were properly perfected, if the collateral has declined in value, the undersecured portion of the debt could be treated as unsecured. . . . Although there is always the possibility that the debtor will lose the property to foreclosure, this situation is still better than the true lease situation in bankruptcy, in that the collateral will remain property of the debtor's estate unless it cannot make any such adequate protection payments, there is no equity in the property, and the property is not necessary for the effective reorganization of the debtor.
>
> In contrast, in the event that a lease were determined to be a true lease, the leased property would be considered property of the lessor, and the debtor would be required to decide whether to assume or reject the lease prior to confirmation of its plan or during such shorter period of time, as ordered by the court, upon the request of a party to the lease. Although there might be no fixed deadline with respect to assumption or rejection, the debtor would be required, pending such decision, to commence making lease payments starting sixty days after the commencement of the bankruptcy case unless the court orders otherwise. Although this situation is similar to that in which the lease is considered a validly perfected secured debt, it differs in the legal ramifications of the debtor's decision to assume or reject the lease. Were the debtor to assume the lease, it would be required to cure all defaults and remain current on the lease going forward. Were the debtor to reject the lease, it would be responsible for paying rejection damages to the lessor for breach of the lease contract.

E. Carolyn Hochstadter Dicker and John P. Campo, *FF&E and the True Lease Question: Article 2A and Accompanying Amendments to UCC Section 1-201(37)*, 7 AM. BANKR. INST. L. REV. 517, 517-18 (1999).

Yet, prior to obtaining these distinct advantages, the Debtor must sustain the burden of proof imposed upon a party who seeks to characterize a transaction in a manner other than what it purports to be in a written agreement. *See, e.g., In re Edison Bros. Stores, Inc.*, 207 B.R. 801, 812, (Bankr. D. Del. 1997) [placing the burden of proof upon a debtor "as the party seeking to

characterize the Lease Agreement as an instrument other than a lease . . . . "]; *In re Murray,* 191 B.R. 309, 316 (Bankr. E.D.Pa. 1996) [identifying a debtor, who sought to characterize a lease agreement as a disguised secured transaction, as the party "whose burden it is to prove that the Lease is other than what it purports to be"]. The quantum of evidence necessary to satisfy that burden is substantial. *In re Integrated Health Services, Inc.,* 260 B.R. 71, 75 (Bankr. D. Del. 2001) (*citing Barney's, Inc. v. Isetain Co., Ltd. (In re Barney's Inc.)*, 206 B.R. 328, 332 (Bankr. S.D.N.Y. 1997) and *Liona Corp. v. PCH Associates (In re PCH Associates)*, 804 F.2d 193, 200 (2d Cir. 1986)).

This Court has painstakingly examined the standards under which an agreement characterized as a lease can be properly construed as creating a disguised security interest. *See In re Triplex Marine Maintenance, Inc.*, 258 B.R. 659 (Bankr. E.D. Tex. 2000). As that opinion recognized, in attempting to maintain the validity of the developed methodologies to distinguish a secured transaction from a lease, while recognizing that new financial tools such as finance leases might encompass certain attributes which the earlier methodologies might have previously identified as evidence of a secured transaction, [9] the Uniform Commercial Code was revised by

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[9] Subsection (C) of the Texas adoption of §1.201(37) addresses this difficulty by recognizing that:

> [a] transaction does not create a security interest ***merely*** because it provides that:
>
> > (i) 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;
> >
> > (ii) 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;

deleting any reference to the intent of the parties and by focusing the inquiry instead upon the economic realities of the transaction. Specifically, §1.201(37) of the UCC, as adopted in Texas in 1989, now defines the term "security interest" as follows:

> (37)(A) "Security Interest" means an interest in personal property or fixtures which secures payment or performance of an obligation.
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> * * * * * *
>
> (B) 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:
>
> > (i) the original term of the lease is equal to or greater than the remaining economic life of the goods;
> >
> > (ii) 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;
> >
> > (iii) 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
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> ---
>
> > (iii) the lessee has an option to renew the lease or to become the owner of the goods;
> >
> > (iv) 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
> >
> > (v) 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.

TEX. BUS. & COMM. CODE ANN. §1.201(37)(C)(Vernon Supp. 2003) (emphasis added).

> (iv) 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.

TEX. BUS. & COMM. CODE ANN. §1.201(37) (Vernon Supp. 2003). Thus, a two-step analysis is required in order to determine whether a finding of a security interest is compelled under §1.201(37)(B). 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.[10]

Under the evidence presented in this case, there can be no finding that the Agreement constitutes a disguised security agreement *per se*. Though the Court could perhaps be convinced that the so-called "termination" rights granted to the Debtor under the Agreement are illusory for the purposes of a §1.201(37)(B) analysis since the Debtor remained contractually bound to pay the accelerated total of all of his future payments due and owing under the lease, *see In re Hoskins*, 266 B.R. 154, 160 (Bankr. W. D. Mo. 2001), the Court need not decide that issue since there is no evidence to substantiate the existence of any of the "bright-line" factors enumerated in §1.201(37)(B) or nor any evidence which suggests that the residual value of the Vehicle at the end of the lease term would be so nominal as to imply the existence of a financing device. The contract establishes the Vehicle's residual value at $11,608.35 at the end of the lease term and the Debtor offered no evidence to challenge the validity of that figure. The Debtor is contractually free to walk away from the Vehicle at the end of the lease term, subject to the

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[10] *In re Taylor*, 209 B.R. 482, 484-85 (Bankr. S.D. Ill. 1997); *In re Murray*, 191 B.R. 309, 315 (Bankr. E.D. Pa. 1996).

payment of a $375 termination fee, plus any additional assessments based upon high mileage or damage to the Vehicle. The Debtor does possess an option to purchase the Vehicle at the end of the lease term, but he can obtain ownership only by paying the Residual Value, plus associated transaction fees and taxes. Nothing in those figures establishes the right of the Debtor to acquire the leased goods at the end of the lease term for some nominal amount of consideration. Neither do the circumstances of the Debtor, as in *Triplex Marine*, compel him to exercise the purchase option as his only sensible alternative. Thus, there can be no *per se* determination of a disguised security interest under §1.201(37)(B) under the evidence presented in this case.

Nevertheless, the Debtor may still prevail in his asserted characterization of the transaction if he can successfully demonstrate that, upon an examination of all the facts, the economic realities of the particular transaction establish the creation of a disguised security interest. *Triplex Marine*, 258 B.R. at 669. However, he has failed to do so.

The Debtor asserted that he looked upon the transaction as simply another auto installment contract payable at $642 per month for 60 months with an $11,600 balloon payment at the end, but the credibility of that testimony is seriously eroded by the fact that the vast majority of the written documentation that the Debtor read and signed on the date he acquired the Vehicle unequivocally established that he was entering into a leasing transaction. The Debtor's presentation of the rider is confusing, but it is not convincing on the relevant point because there never was a retail installment sales contract in existence, the Debtor never borrowed money from the Ford Motor Credit Company as the rider indicates, nor is there anything within the parameters of this transaction which creates a lien in the amount of $20,543.92 as the rider suggests. While it utilizes terms associated with retail transactions, the rider provides no real

insight nor support for the Debtor's proposition that this leasing arrangement was always actually intended to be a secured transaction.

The only other evidence presented was the testimony of Rick Bonnette, a finance manager for a local Ford dealership in the Beaumont area. While he testified that, from his perspective, he agreed with the Debtor's viewpoint that leasing is simply another means of financing the purchase of an automobile in modern times, his failure to appreciate the legal distinctions between a lease and a secured transaction vastly depreciates the value of his testimony. While it is understandable that a dealer's representative would view leasing and financing in a similar vein because they both accomplish the same purpose for the dealer — i.e., moving the vehicle from inventory for an acceptable price — one cannot logically deduce from that shared purpose, as Mr. Bonnette did, that leasing and financing are the same thing. It certainly does not recognize the fact that the Debtor does not currently own this truck. It does not recognize that, assuming that the Debtor fulfills all of his contractual obligations, including making all 60 payments in a timely manner, the Debtor will still not own this truck at the end of the contractual period. It does not recognize that, unlike the conventional financing at a market interest rate under which the Debtor could have likely owned this vehicle within the 60-month contractual period for the same approximate amount of money that he was required to pay under the agreement, this Debtor will be required to pay (or, more horribly, finance) yet another $11,600 in order to claim ownership of a five-year-old vehicle. A close examination of the numbers derived from this transaction reveals that, from the Debtor's economic perspective, this agreement was far from the equivalent of financing with a reduced monthly amount and a balloon at the end. For the Debtor, this agreement is horrendously worse.

Nevertheless, while the evidence conclusively demonstrates that this was a ghastly economic decision by the Debtor, and that perhaps rejection of the agreement should be seriously considered, such evidence is insufficient to alter the conclusion that the agreement between the Debtor and Bank of America is a true lease under the applicable analysis. Accordingly, the Court concludes that the Debtor's request to characterize the leasing arrangement as a disguised sale of the Vehicle to the Debtor must be denied. The Court will proceed to schedule a new hearing date to consider the remaining issues raised by the Bank's motion for relief from the automatic stay.

This memorandum of decision constitutes the Court's findings of fact and conclusions of law[11] as to the initial matters raised in this contested matter pursuant to FED. R. CIV. P. 52, as incorporated into contested matters in bankruptcy cases by FED. R. BANKR. P. 7052 and 9014. An interim order shall be entered which is consistent with this memorandum.

SIGNED: MAR 31 2003.

BILL PARKER
UNITED STATES BANKRUPTCY JUDGE

| | | | |
|---|---|---|---|
| **cc:** | **James King, Atty for Movant** | **Fax:** | **409-860-9199** |
| | **Robert Barron, Atty for Debtor** | **Fax:** | **409-724-7739** |

[11] To the extent that any finding of fact is construed to be a conclusion of law, it is hereby adopted as such. To the extent any conclusion of law is construed to be a finding of fact, it is hereby adopted as such. The Court reserves the right to make additional findings and conclusions as necessary or as may be requested by any party.

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