UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF NEW YORK

IN RE:

METAL TRANSPORTATION SYSTEMS, INC.
Debtor

CASE NO. 02-66483
Chapter 11

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Hon. Stephen D. Gerling, Chief U.S. Bankruptcy Judge

MEMORANDUM-DECISION, FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER

Before the Court is a motion filed on February 10, 2003, by Community First Financial, Inc. (the "Bank"), requesting adequate protection payments from Metal Transportation Systems,

Inc. ("Debtor") pursuant to §§ 363(e) and 365(d)(10) of the Bankruptcy Code, 11 U.S.C. §§ 101-1330 ("Code"). The motion also requests the establishment of a deadline for assumption or rejection of a lease by the Debtor pursuant to Code § 365(d)(2) or, in the alternative, relief from the automatic stay pursuant to Code § 362(d). Opposition to the motion was filed on behalf of the Debtor on February 20, 2003.

The motion was originally argued on March 4, 2003, at the Court's regular motion term in Syracuse, New York, at which time the parties were directed to submit memoranda of law on the limited issue of whether a "Master Lease Agreement" and subsequent "schedules" executed on March 12, 1998 ("Agreement"), constitute a true lease or an installment sales contract/security agreement for purposes of the relief sought by the Bank. The matter was submitted for decision on March 18, 2003.

JURISDICTIONAL STATEMENT

The Court has core jurisdiction over the subject matter and the parties of this contested matter pursuant to 28 U.S.C. §§ 1334, 157(a), (b)(1), (b)(2)(A) and (O).

FACTS

The Debtor filed a voluntary petition for relief pursuant to Chapter 11 of the Code on October 24, 2002. The Debtor is a national transportation company, transporting aluminum

products throughout North America. The Bank is listed on Debtor's Schedule G,[1] Executory Contracts and Unexpired Leases, as being paid $6,430 monthly for "leases for equipment." It is not listed on Debtor's Schedules D or F as a secured or unsecured creditor.

On or about March 12, 1998, the Debtor entered into the Agreement with Vision Financial Group, Inc. ("Lessor"), a Pennsylvania corporation with a place of business in Pittsburgh, Pennsylvania. *See* Debtor's Memorandum of Law, filed March 18, 2003 at Exhibit A. According to the Agreement, Lessor leased ten 1998 Ravens Eclipse Flatbed Trailers ("Equipment") to the Debtor,[2] which Lessor purchased on or about March 12, 1998, from STS Truck Equipment & Trailer Sales in Syracuse, New York, for a total price of $350,000.

The Agreement calls for the Debtor to make 59 monthly payments of $6,430, commencing April 5, 1998, and a final payment of $10,184.70 on May 5, 2003, for a total of $385,800.[3] The Agreement also stipulates that the Lessor shall retain full legal title to the Equipment (Section 1.1), that the Agreement is a true lease and not a security instrument (Section 1.1), that the Debtor is responsible for all maintenance (Section 3.2), taxes (Section 3.3), risk of loss (Section 3.4(a)), and insurance costs (Section 3.5(a)). The Agreement also states that Lessor is entitled to claim all interest and depreciation deductions for Federal income tax purposes (Section 3.13). The Debtor was required to pay a security deposit of one month's rent under the terms of the Agreement (Section 5.1).

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[1] The Bank indicates that it is incorrectly identified in Schedule G as "Community Bank."

[2] The ten trailers are listed in Debtor's Schedule B under Exhibit 2, identifying Personal Property alleged to belong to the Debtor.

[3] Under the terms of the original Agreement, the last payment was due March 5, 2003. However, pursuant to an amendment, dated February 9, 2001, no payments were due on January 5, 2001 and February 5, 2001, thereby extending the last payment due date to May 5, 2003.

The Terminal Rental Adjustment Rider to the Agreement gives the Debtor the option to purchase the Equipment at the expiration of the lease term for the Estimated Residual Value, defined therein as 20% of the original cost of the Equipment or $70,000. *See* Exhibit "A" of Debtor's Memorandum of Law. If the Debtor did not choose to purchase the Equipment at the Estimated Residual Value, the Lessor would sell the Equipment, and either refund any net proceeds of sale (gross proceeds less fees, sales taxes and expenses incident to the sale) in excess of the Estimated Residual Value, or charge Debtor for any deficiency of net sale proceeds under the Estimated Residual Value.

On or about May 15, 1998, Lessor assigned all its "right, title and interest (including the right to receive rent payable from June 5, 1998 through March 5, 2003) in and to the following described Lease Schedule . . . ." to the Bank ("Assignment"). *See* Debtor's Memorandum of Law at Exhibit B. The Assignment was made pursuant to a Security Agreement, dated April 22, 1998, executed by the Lessor and the Bank. *See* Security Agreement, attached as Exhibit B of Debtor's Memorandum of Law. The Assignment expressly states that the Lessor "does not transfer title to the Bank in the Goods leased . . . . Rather, this Assignment transfers only Lessor's right to payment and other rights under the above described Lease and grants the Bank merely a security interest in the [Equipment]." *See* Assignment. According to the terms of the Security Agreement, the Lessor is the sole owner of the Lease and "either the Lessor has good and marketable title to the [Equipment] free and clear of all security interests . . . or, with respect to any Lease that is deemed an installment sale or loan, Lessor has a perfected first security interest in the [Equipment] covered by such Lease securing the Lessee's obligations under such Lease." *See* Security Agreement at ¶ 4.c. In addition, under the terms of the Security Agreement as security for the payment of all rent under the Lease and as security for the payment and

performance of Lessor's repurchase obligations, the Bank was granted a security interest in, *inter alia*, (1) the Equipment, (2) the Lease and the Lessor's rights thereunder, including the right to receive the lease payments or "Rent"and the right to exercise Lessor's rights and remedies upon a default, (3) the Rent and (4) proceeds of any of the foregoing. *See* Security Agreement at ¶ 3. The Bank did not assume any of the Lessor's obligations under the Lease. *See id.* at ¶ 12(a) and letter, dated May 12, 1998, from the Lessor to the Debtor informing it of the assignment and requiring that all payments of "rent" be made directly to the Bank, referred to therein as the "Secured Party." According to the Security Agreement, the Bank was authorized to "exercise any of the rights and remedies available to it under the Uniform Commercial Code to foreclose or otherwise enforce its security interest granted hereunder in the Lease and the [Equipment] covered by such Lease . . . ." *See* Security Agreement at ¶ 9.a.

ARGUMENT

The Debtor maintains that the Agreement actually is an installment sales contract under which the Bank was granted a security interest in the Equipment. It is the Bank's position that the Agreement is a "true lease" under relevant statutes and case law, which must be assumed or rejected by the Debtor pursuant to Code § 365. In particular, the Bank contends that pursuant to Title 13 of Commercial Code, § 1201(6) of the Pennsylvania Consolidated Statutes ("Pa.C.S. 1201(6)"),[4] the Agreement constitutes a lease because (1) the original lease term was not equal

[4]The Agreement contains a choice-of-law provision stating that its terms are governed by the laws of the Commonwealth of Pennsylvania. Pa.C.S. § 1201(6) was amended in 1992 to incorporate revised § 1-201(37) of Article 2A of the Uniform Commercial Code ("UCC"). *See In re Murray*, 191 B.R. 309, 313 (Bankr. E.D. Pa.), aff'd 201 B.R. 381 (E.D.Pa. 1996).

to or greater than the economic life of the goods; (2) the lessee was not bound to renew the lease or become the owner; (3) the option to renew was for more than nominal consideration; and (4) the option Debtor had to become the owner of the goods, at 20% of the original purchase price, was not nominal.

DISCUSSION

Whether an equipment lease is to be treated as a "true lease" or an installment sales contract/security agreement "is one of the most vexatious and oft-litigated issues under the Uniform Commercial Code." *In re QDS Components, Inc.*, 292 B.R. 313, 323 (Bankr. S.D. Ohio 2002) (citations omitted). The Bank argues that the Agreement appears on its face to be a lease, and that the Agreement explicitly states that it is a true lease rather than a security instrument. However, this Court has previously held that such references in the document itself are not controlling. *See In re Owen*, 221 B.R. 56, 62 (Bankr. N.D.N.Y. 1998); *see also In re Chicago Coastal Motor Express, Inc*., 1992 WL 309184 at *12 (Bankr. N.D. Ind. 1992), citing *In re Coors of the Cumberland, Inc*., 19 B.R. 313, 316 (Bankr. M.D. Tenn. 1982) (noting that "a party cannot avoid the legal consequences of an installment sales contract by simply labeling a financing agreement as a lease.").

The determination of whether a lease can be construed as a "true" lease or a conditional sale is a matter of state law. *See Owen*, 221 B.R. at 60, citing *In re Edison Bros. Stores, Inc.*, 207 B.R. 801, 807 (Bankr. D.Del. 1997)); *see also In re PSINet, Inc.*, 271 B.R. 1, 43 (Bankr.

S.D.N.Y. 2001), citing *In re Powers*, 983F.2d 88, 90 (7th Cir. 1993). It is the Debtor who has the burden of proof in demonstrating that the Agreement is not a true lease. *See Murray*, 191 B.R. at 316; *Owen*, 221 B.R. at 60.

As noted at Footnote 5, *supra*, the Agreement is governed by the laws of the Commonwealth of Pennsylvania. In pertinent part, Pa.C.S. § 1201 (6), reads as follows:

(6) Determination of lease or security interest. Whether a transaction creates a lease or security interest is determined by the facts of each case; however:

(i) 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;
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> (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.

(ii) 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 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.
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(iii) For purposes of determining whether the transaction is a lease or a security interest:

> (A) Additional consideration is not nominal if:
>
> > (I) when the option to renew the lease is granted to the lessee, the rent is stated to be the fair market rent for the use of the goods for the term of the renewal determined at the time the option is to be performed; or
> >
> > (II) when the option to become the owner of the goods is granted to the lessee, the price is stated to be the fair market value of the goods determined at the time the option is to be performed
> >
> > Additional 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.
>
> (B) "Reasonably predictable" and "remaining economic life of the goods" are to be determined with reference to the facts and circumstances at the time the transaction is entered into.

"Courts should look to the economic reality of the transaction, rather than to its form in determining whether there has been a sale or true lease." *Edison Bros.*, 207 B.R. at 809; *see also Murray*, 191 B.R. at 314 (indicating that the "focus should be on the economics of the transaction rather than on the intent of the parties."). Pa.C.S. § 1201(6) (and UCC § 1-201(37)) states that whether a transaction creates a lease or security instrument is determined by the facts of each case. At the same time, it also provides "an objective test 'by setting out a bright line test whereby, as a matter of law, a transaction creates a security interest.'" *PSINet, Inc.* 271 B.R. at 43 (citing *Owen*, 221 B.R. at 60). [5] The statute states that a lease will be construed as a security

[5] As 13 Pa..C.S.A. § 1201 is based on U.C.C. § 1-201(37), opinions from other jurisdictions can serve as guidance in interpreting this statute. *See In re Murray*, 191 B.R. at 314.

interest if a debtor cannot terminate the lease, and if one of four enumerated conditions is present in the lease. *See Murray*, 191 B.R. at 315; *see also PSINet, Inc.* 271 B.R. at 43-44, citing *Owen*, 221 B.R. at 61 (stating that a contract that "prohibits the lessee from terminating the obligation [...] and [which] meets any of the four enumerated conditions will 'establish that the parties entered into a security agreement"'). In the present case, the terms of the Agreement did not allow the Debtor to terminate the lease. Thus, the Court must examine whether any of the four enumerated terms of Pa.C.S. § 1201 have been met. [6]

> 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 lease property such that there will be nothing of value to return at the end of the lease, the transaction is in essence a sale.

Matter of Marhoefer Packing Co., Inc., 674 F.2d 1139, 1145 (7th Cir. 1982) (citation omitted). Conversely, "if the lessor expected a remaining useful life after the expiration of the lease term, it can be reasonably inferred that it expected to retain substantial residual value in the leased property at the end of the lease term and that it, therefore, intended to create a true lease." *Edison Bros.*, 207 B.R. at 816 (citation omitted).

Regarding § 1201 (6)(i)(A), the first residual value factor, Debtor maintains that the term of the original lease is equal to or greater than the remaining economic life of the goods. It grounds this contention on the fact that the Agreement stipulates that the Equipment is to be classified as "five year property" for Federal income tax purposes. *See* Equipment Schedule No.

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[6] These four enumerated factors have also been referred to as "residual value factors." *See PSINet, Inc.*, 271 B.R. at 45.

1 at 3. However, the Internal Revenue Code defines "five year property" as any property having an economic life of more than four and less than ten years. *See* § 168(e) of the Internal Revenue Code ("I.R.C."), 26 U.S.C. § *1 et. seq.* Thus, this classification is easily consistent with the Equipment having an economic life in excess of the five year term of the original lease.

The Bank contends that it is not unusual for trailers of equal longevity to be bought and sold and directs the Court to the fact that the Debtor was able to renew the lease for an additional 12 or 24 months for a market rent in support of the argument that the trailers have an economic life beyond the term of the lease. In fact, the $120,000.00 value Debtor places on the Equipment in its Schedules argues against its own proposition that there is no remaining value in the Equipment at the May 2003 end of the original lease term.

Furthermore, it is important to note that 13 Pa.C.S. § 1201 dictates that "remaining economic life of the goods" is to be determined with reference to the facts and circumstances at the time the transaction is entered into. The best indicator of what the economic life of the goods was expected to be when the Agreement was entered into is the Estimated Residual Value, stipulated in the Agreement at 20% of the original cost of the Equipment or $70,000. The fact that the Equipment was expected to retain fully one-fifth of its original value at the end of the five year term clearly evinces an expectation on each party's part that the Equipment would have an economic life extending beyond the May 2003 termination of the Agreement. The Court concludes that the Debtor has not met its burden of demonstrating that the first residual value factor applies to the Agreement.

Debtor does not contend that the second or third residual value factors, Pa.C.S. § 1201(6)(i)(B) and (C), trigger a recharacterization of the Agreement from a lease to an installment sales contract under the statute. The Debtor maintains, however, that under the fourth

residual value factor, Pa. C.S. § 1201 (6)(i)(D), the Agreement constitutes an installment sales contract because the Debtor had the option to purchase the Equipment for nominal additional consideration.

By enacting UCC 1-201(37), "the drafters attempted to 'reassert the significance of residual value as a the touchstone of the common law definition of true leases.'" *Murray*, 191 B.R. at 313, quoting Naples, *A Review and Analysis of the New Article 2A*, 93 COM. L.J. 342, 349 (1988). Thus, the focus of the Court's analysis is on whether the Lessor shifted the residual value in the property to the Debtor, as lessee, with the payment of nominal consideration as a purchase option, thereby creating a security agreement rather than a "true" lease. *See Owen*, 221 B.R. at 61.

It is the value anticipated by the parties at the time the Agreement was executed that determines whether the option price is nominal. *See Marhoefer Packing*, 674 F.2d at 1145; s*ee also In re Edison Bros.*, 207 B.R. at 811.[7] The Court must determine whether the option price of $70,000, which represents 20% of the original purchase price of the Equipment and approximately 18% of the total rental payments under the Agreement is nominal.[8] Debtor argues

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[7] A number of courts differ on this point; a minority have held that it is the fair market value at the time the option is exercised which should be the benchmark value. *See APB Online, Inc*. 259 B.R. 812, 818 (Bankr. S.D.N.Y. 2001). Indeed, even the *Marhoefer* court confusingly espouses each of the two contrary standards. *See Marhoefer,* 674 F.2d at 1144, 1145. Even under the minority standard, however, and using Debtor's unsupported fair market value of $120,000, the option price of $70,000 constitutes nearly 60% of market value, hardly nominal consideration.

[8] Courts have noted that what is deemed to constitute "nominal consideration" covers a wide range of values, from 2.7% to 10% (of total rental payments). *See Orix Credit Alliance, Inc*., 946 F.2d at 1261 (collecting cases and finding that 12% of total rental payments on tractor trailers was nominal).

that 20% of the original equipment cost is nominal because it is less than Debtor's reasonably predictable cost of performing under the lease if the option is not exercised. In order to make this point, the Debtor starts with the assumption that it would be responsible for any shortfall in the event that it failed to exercise its purchase option and the Equipment was sold for less than $70,000. However, this is a less than convincing argument given the Debtor's contention that the Equipment had a value of $120,000 as of the date of the filing of its petition. The Court concludes that the Debtor has failed to establish that the option to become the owner of the Equipment for the Estimated Residual Value of $70,000 is only "nominal" consideration.

Although not related to one of the four residual value factors contained in Title 13 of the Pa. C.S. § 1201(6), Debtor maintains that because the Agreement calls for payments totaling $385,800 over the term of the Agreement, the Court should take the $35,800 excess over the original purchase price of the Equipment into account when determining whether the Agreement constitutes a security interest. However, this ignores the majority of case law finding that the aggregate rental payments over time are likely to exceed the original purchase price of the equipment given the time value of money. *See Owen,* 221 B.R. at 61; s*ee also Edison Bros.*, 207 B.R. at 814.

Lastly, Debtor states that it holds title to the Equipment and has been taking advantage of the tax benefits that go along with ownership. The contention that this makes the Agreement an installment sales contract ignores the fact that 13 Pa.C.S. § 1201(6) (and UCC § 1-201(37)) looks "solely to the terms of the agreement" when distinguishing between a true lease and a conditional sales agreement or security interest. *PSINet, Inc.*, 271 B.R. at 43. The Agreement entered into by Debtor and Lessor explicitly provides the Lessor, not the Debtor, with the right to claim interest and depreciation deductions for Federal income tax purposes. Section 3.13,

Agreement. It also explicitly states that Lessor shall retain full legal title to the Equipment. Section 1.1, Agreement. Whether or not the Debtor holds legal title to the Equipment is an issue to be resolved by the Debtor and the Lessor. It is not an issue the Court need address herein.

Based on the above analysis, the Court concludes that the Agreement executed by the Lessor and the Debtor on March 12, 1998, constitutes a true lease. However, this conclusion does not end the Court's discussion. For purposes of the relief being sought by the Bank, the Court's focus must shift to the relationship established between the Lessor and the Bank pursuant to the Security Agreement of April 22, 1998, and the Assignment of May 15, 1998.

According to those documents, and contrary to the Bank's contention that it owns the Equipment, it is clear that the Bank was merely granted a security interest in the Equipment, as well as in the lease and the lease payments to be made by the Debtor ("Collateral"). The documents are explicit in defining the Bank's position. It was assigned the lease payments and was granted a security interest in the Collateral as security for the payment of all rent under the lease and for payment and performance of the Lessor's repurchase obligations. Indeed, the letter from the Lessor to the Debtor, dated May 12, 1998, makes it clear that the Bank is the "secured party."

The question is whether by virtue of the Assignment, the Bank has standing to compel the Debtor to assume or reject the lease. Code § 365(d)(2) permits the Court to order the assumption or rejection of a lease within a specified time period "on request of any party to such contract or lease . . . ." Code § 365 focuses on the adjustment of rights between the parties to the lease. *See In re Austin Development Co.*, 19 F.3d 1077, 1083 (5th Cir. 1994). The Bank, of course, is not a party to the lease. It is not required to perform any of the Lessor's obligations under the lease. Furthermore, based on the documents before this Court, the Lessor continues

to possess the incidents of ownership of the Equipment leased to the Debtor, except the right to collect the lease payments in connection with its use. Accordingly, the Bank does not have the right to invoke Code § 365(d)(2) as a "party to such lease." *See In re Riverside Nursing Home*, 43 B.R. 682, 685 (Bankr. S.D.N.Y. 1984).

Insofar as the Bank seeks relief from the automatic stay pursuant to Code § 362(d), the Court finds that the Bank's secured status rests on an agreement not with the Debtor but with the Lessor. The Assignment merely entitled it to receive payments from the Debtor and, accordingly, its status with respect to the Debtor is that of an unsecured creditor. Under those circumstances, it is not entitled to relief from the automatic stay.

Based on the foregoing, it is hereby

ORDERED that the Bank's motion seeking adequate protection payments pursuant to Code §§ 365(e) and 365(d)(10) is denied; it is further

ORDERED that the Bank's motion seeking the establishment of a deadline for the assumption of the Lease by the Debtor pursuant to Code § 365(d)(2) is denied; and it is finally

ORDERED that the Bank's motion seeking relief from the automatic stay pursuant to Code § 362(d) is denied.

Dated at Utica, New York

this 21st day of July 2003

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STEPHEN D. GERLING
Chief U.S. Bankruptcy Judge