IT IS SO ORDERED.

Kay Woods

Honorable Kay Woods
United States Bankruptcy Judge

Dated: July 22, 2009
01:58:38 PM

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO

IN RE:	*	**CASE NUMBER 09-41366**
DAMOND MARCELL McELROY and LILLY MAE McELROY,	*	**CHAPTER 13**
	*	**HONORABLE KAY WOODS**
Debtors.	*	

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MEMORANDUM OPINION REGARDING OBJECTION OF MANOR INSURANCE AGENCY, INC. TO CONFIRMATION OF DEBTORS' CHAPTER 13 PLAN

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This cause is before the Court on Objection to Confirmation of the Chapter 13 Plan ("Objection to Confirmation") (Doc. # 18) filed by Manor Insurance Agency, Inc. ("Manor") on May 12, 2009. The Court held a hearing on the Objection to Confirmation on June 18, 2009. The parties represented that the feasibility of the chapter 13 plan depended upon a determination whether the debt to Manor was based on a true lease or disguised security agreement. As a consequence, the Court requested the parties to brief the issue and

submit simultaneous briefs no later than July 16, 2009. Manor filed Memorandum in Support of Objection to Confirmation of the Chapter 13 Plan ("Manor's Brief") (Doc. # 34) on July 16, 2009. That same day, Debtors Damond Marcell McElroy and Lilly Mae McElroy ("Mrs. McElroy") (collectively, "Debtors") filed Debtor's [sic] Brief in Response to Manor Insurance Agency's Objection to Confirmation of the Chapter 13 Plan ("Debtors' Brief") (Doc. # 35).

This Court has jurisdiction pursuant to 28 U.S.C. § 1334 and the general order of reference (General Order No. 84) entered in this district pursuant to 28 U.S.C. § 157(a). Venue in this Court is proper pursuant to 28 U.S.C. §§ 1391(b), 1408, and 1409. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(A), (L) and (O). The following constitutes the Court's findings of fact and conclusions of law pursuant to FED. R. BANKR. P. 7052.

For the reasons set forth below, this Court finds that the debt owed to Manor is based upon a security agreement rather than a true lease. As a consequence, the Court will overrule the Objection to Confirmation.

I. FACTS

By way of background, Debtors filed a voluntary petition pursuant to chapter 13 of the Bankruptcy Code on April 20, 2009 ("Petition Date"). Debtors also filed a chapter 13 plan on the Petition Date. The chapter 13 plan provided for a monthly payment of $300.00 per month for sixty months. Debtors' chapter 13 plan listed "Manor Insurance" as having a secured claim in the amount of

$5,000.00 (as the value of the security with no unsecured amount) at an interest rate of 4.25%.[1]

The facts underlying the claim asserted by Manor are not in dispute. The parties agree that, on March 4, 2009, Mrs. McElroy entered into an agreement with Manor styled "Motor Vehicle Lease Agreement – Closed End" ("Vehicle Agreement"), which provided for the "lease" of a 2002 Ford Explorer ("Explorer") upon the following terms: (i) amount due at signing or delivery in the amount of $3,453.68, which included (a) "capitalized cost reduction" of $2,095.00, (b) sales tax in the total amount of $558.68, (c) initial title, registration and license fees in the amount of $300.00, (d) first monthly payment of $250.00 and refundable security deposit of $250.00; and (ii) a 26-month term (initial payment plus 25 monthly payments) for a total of $6,500.00 in monthly charges. The Vehicle Agreement sets forth the "TOTAL OF PAYMENTS (The amount you will have paid by the end of the Lease)" as $9,453.68.[2] The Vehicle Agreement further provided for a "Termination Fee (If you do not purchase the Vehicle)" of $250.00.[3] The Explorer is listed as

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[1]The $5,000.00 secured amount is not at issue. Debtors have conceded that "Manor Insurance Agency will receive the full value of their [sic] vehicle because the Ford Explorer was purchase [sic] within 910 days of the filing of their petition." (Debtors' Brief at unnumbered 4-5.)

[2]Manor reduced the "total of payments" Mrs. McElroy was required to pay pursuant to the agreement by: (i) the first monthly payment of $250.00 (section 7(A)(3)), and (ii) the refundable security deposit (section 7(A)(4)).

[3]Since Mrs. McElroy was required to pay: (i) $250.00 in the event she purchased the Explorer, or (ii) a "termination fee" of $250.00 in the event she failed to purchase the Explorer, it is hard to understand how this $250.00 "deposit" can be considered "refundable." It appears to the Court that this amount is mischaracterized as a refundable deposit.

having an odometer reading of 98,617 miles. Manor states that the "agreed upon value of the vehicle at the time of the agreement was $6,995.00[,]" although this number does not appear on the face of the Vehicle Agreement. (Manor Brief at unnumbered 1.)

II. LEGAL ARGUMENTS

Manor asserts that this Court should sustain its Objection to Confirmation because the Vehicle Agreement is a true lease and cannot be amortized by Debtors over the course of their proposed sixty month plan. Debtors contend that the Vehicle Agreement is, in reality, a security agreement for the purchase of the Explorer. Both parties rely entirely on the Vehicle Agreement and case law to support their positions.

Both parties agree that this Court should look to state law – in this case the law of Ohio – to determine if the Vehicle Agreement is a true lease or a security agreement. (Manor Brief at unnumbered 1; Debtors' Brief at unnumbered 2.) Moreover, both parties assert that O.R.C. § 1301.01(KK) (Ohio's version of the Uniform Commercial Code and definition of "Security interest") is the governing law. O.R.C. § 1301.01 provides:

> (KK)(1) "Security interest" means an interest in personal property . . . that secures payment or performance of an obligation. . . .
>
> (2) 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 if any of the following applies:

(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 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.

(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.

O.R.C. § 1301 (Anderson 2002).

A. True Lease Argument

Manor has the burden of proof that the Vehicle Agreement is a true lease. *Hanes v. Vital Prod. Co.*, (*In re Vital Prod. Co.*), 210 B.R. 109, 111 (Bankr. N.D. Ohio 1997) ("[B]urden of proof is upon the party seeking the recovery as a true lease who must meet its burden of proof by a preponderance of the evidence standard.") Manor argues that the Vehicle Agreement is a true lease based on the following factors:

1. The lease provides for Mrs. McElroy to purchase the Explorer at the end or the lease term. (Manor Brief at unnumbered 2.)
2. The $250.00 purchase price at the end of the lease term is a "reasonable determination of fair market value of this vehicle at the end of the lease term due to depreciation and the fact that the vehicle will be almost 10 years old and likely have accumulated thousands of

additional miles by that time." (*Ibid*.)

3. Debtors[4] are responsible for payment of taxes, insurance and registration fees, as well as service and maintenance of the Explorer. (*Ibid*.)

4. The Vehicle Agreement subjects Debtors to penalties for loss, damage, or danger to the Explorer by requiring them to "turn over any loss proceeds received from their insurance company as well as pay a $250.00 early termination fee." (*Id*. at unnumbered 3.)[5]

5. "Debtors are subject to penalties for early termination of the lease including payment for [sic] any fees and sales/tax uses, all past monthly payments still due, the amount of the adjusted lease balance, and a $250.00 turn-in fee." (*Ibid*.)

B. Disguised Security Interest Argument

Debtors contend that the Vehicle Agreement is a security

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[4]Manor refers to Debtors throughout its Brief, but the Vehicle Agreement was signed by only Mrs. McElroy.

[5]The Vehicle Agreement has blank spaces for "insurance verification," and further provides: "You authorize us to verify and give your agent authorization to place the minimum coverage required by this Lease (see Section 16)." The insurance information is not completed. Furthermore, the Court could find no "Section 16" on the copies of the Vehicle Agreement furnished by either Manor or Debtors although Section 1.R is captioned "Insurance" and requires that Manor be named as a loss payee. In addition, the Vehicle Agreement, which is a form agreement apparently prepared by Manor, is confusing and inconsistent. The Vehicle Agreement initially defines "you" and "your" to mean the Lessee (*i.e*., Mrs. McElroy) and "we," "us" and "our" to mean Manor. Despite these initial definitions, the Section numbered "1" with Subsections "A" through "S" appears to use: (i) "I" to refer to Mrs. McElroy (see subsections A, D, E, G, H, I, J, K, M, O and S); (ii) "you" to mean Mrs. McElroy (see subsections B, C, R); and (iii) "you" to mean Manor (see subsections A, G, H, J, L). The Vehicle Agreement is, at best, ambiguous and confusing and should be construed against Manor, as its drafter.

interest rather than a true lease, based on the following:

1. Designation of the Vehicle Agreement as a "lease" is not determinative. (Debtors' Brief at unnumbered 2.)
2. The purchase option is the critical factor in determining if an agreement is a true lease. Where, as here, the purchase price is nominal consideration, the agreement is not a true lease. (*Id*. at unnumbered 2-3.)
3. Here, the $250.00 purchase price at the end of the term of the agreement meets the two-pronged test as being nominal when (a) considered as a percentage of the original cost, and/or (b) considered as a percentage of the fair market value at the time the option is exercised. (*Id*. at unnumbered 4.)
4. Realistically, there is no purchase price under the terms of the Vehicle Agreement because the termination fee is the same as the purchase price, *i.e.*, $250.00, so Mrs. McElroy will be required to pay $250.00 at the end of the term of the agreement whether or not she purchases the Explorer. (*Id*. at unnumbered 1.)

III. LEGAL ANALYSIS

Some of the factors cited by Manor in support of its contention that the Vehicle Agreement is a true lease actually cut against its position. Manor relies on the fact that Mrs. McElroy is required to pay sale taxes and keep the vehicle insured, with Manor as a loss payee, to support the argument that the Vehicle Agreement is a true

lease. O.R.C. § 1301.01(KK)(3) provides that "merely because" under an agreement 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[,]" the transaction does not create a security interest. O.R.C. § 1301.01 (Anderson 2002). The statute does not state that inclusion of these provisions creates a true lease; rather, because such items are usually indicative of transference of ownership, the statue states that "merely because" they are included does not automatically transform the agreement into a security interest. The inclusion of these particular terms does nothing to bolster Manor's argument that the Vehicle Agreement is a true lease.

The Court finds that O.R.C. § 1301.01(KK)(2) is the determinative statute in the instant case. Here, there is no question that Mrs. McElroy was required to pay Manor consideration "for the right to possession and use of" the Explorer and such was an "obligation for the term of the lease not subject to termination" by Mrs. Elroy. The Vehicle Agreement did not permit Mrs. McElroy to terminate the agreement "early" without paying the entire amount due under the Vehicle Agreement, plus a $250.00 termination fee. As a consequence, if any of the criteria in § 1301.01(KK)(2)(a) through (d) apply, then the transaction creates a security interest.

Subsection (d) provides that an agreement is a security interest if "[t]he 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." O.R.C. § 1301.01(KK)(2)(d) (Anderson 2002). Manor asserts that the $250.00 purchase price makes the Vehicle Agreement a true lease.

> Thus, [Manor] meets the criteria required by courts and under Ohio law as consideration is required to purchase the vehicle at the end of the lease term. Two-hundred and fifty dollars is a reasonable determination of fair market value of this vehicle at the end of the lease term due to depreciation and the fact that the vehicle will be almost 10 years old and likely have accumulated thousands of additional miles by that time.

(Manor Brief at unnumbered 2.) For the reasons set forth below, this Court finds that the $250.00 purchase price is nominal and, thus, pursuant to the terms of O.R.C. § 1301.01(KK)(2)(d), the Vehicle Agreement is explicitly a security interest rather than a true lease.

Despite Manor's description of $250.00 as the likely fair market value of a ten-year old vehicle, this Court takes notice of the fact that the Kelly Book retail value of a 2000 Explorer with 130,000 miles, which is two years older and has 32,000 more miles than the Explorer in the instant case,[6] is currently $4,850.00. This amount is far greater than the $250.00 purchase price. Indeed, the purchase price is: (i) only approximately five per cent (5%) of the current fair market value of a vehicle the same age the Explorer would be at the end of the term of the Vehicle Agreement; and (ii)

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[6]Since the Vehicle Agreement is for 26 months, looking to the fair market value of the same type of vehicle (*i.e.*, Ford Explorer) that is two years older provides a reasonable comparison of fair market value at the end of the term of the Vehicle Agreement. Furthermore, the Vehicle Agreement provides for Mrs. McElroy to drive only 15,000 miles each year, which is less than the mileage difference accounted for by the Court.

approximately 3.5% of the initial value of the Explorer.

In the instant case, the purchase price appears to be nominal because a disproportionately large amount of the total payment is front-end loaded. Mrs. McElroy paid $2,095.00 initially as "capitalized cost reduction." This was approximately one-third the entire "agreed value" of the Explorer at the time of signing. (Manor Brief at unnumbered 1.) After paying an additional $6500.00, Mrs. McElroy would have the option to purchase the Explorer for $250.00. If she chose not to purchase the Explorer at the end of the 26 month term of the Vehicle Agreement, she would be required to return the Explorer in good working order and cosmetic appearance (*see* Vehicle Agree. at Sec. 1.K) in order to receive the "refundable deposit" of $250.00. The refundable deposit is the same amount as the purchase price option. No reasonable person would return the Explorer after paying $9,703.68. Forfeiting the refundable deposit as the purchase price would permit Mrs. McElroy to retain the vehicle as her own, which she could then (a) continue to use without a car payment, (ii) trade in for another vehicle, or (ii) sell outright for probably more than $250.00.

The Sixth Circuit Court of Appeals has held that an agreement is a true lease when the purchase price option at the end of the lease term is equivalent to fair market value, but the contrary is true when the purchase price is nominal. The Court of Appeals found a purported lease agreement to be a security interest in *Consumers Lease Network, Inc. v. Puckett (In re Puckett)*, 838 F.2d 471, 1988

WL 7404 (6th Cir. 1988). In that case, the bankruptcy court had found the agreements to lease consumer goods with options to buy to be security agreements, based, in part, upon nonrefundable security deposits that were thinly disguised down payments. The Court of Appeals agreed with the bankruptcy court that "because the transactions were structured to require large payments at the beginning of the contracts, economic realities forced the lessees to continue with payments and to exercise the options to buy or lose a great deal of money." *Id*. at *6. *Accord*, *In re Vital Prod. Co.*, 210 B.R. 109, 112 (Bankr. N.D. Ohio 1997) (option price to acquire ownership was quite nominal in view of the stated value of the goods); and *In re Baker*, 91 B.R. 426, 428 (Bankr. N.D. Ohio 1988) (purchase price equal to 9% of the total lease payments was nominal, making the agreement a security interest). *Cf*. *Jahn v. M.W. Kellogg Co*., *Inc.* (*In re Celeryvale Trans., Inc*.), 822 F.2d 16, 18 (6th Cir. 1987) (lease was a true lease because it provided for debtor to obtain appraisals at the end of the lease term to determine purchase price; thus, there was no evidence that debtor would be economically compelled to invoke the purchase option); and *Estep v*. *Fifth Third Bank of N.W. Ohio* (*In re Estep*), 173 B.R. 126, 128 (Bankr. N.D. Ohio 1994) (lease was a true lease because stipulated value of the fair market value of the leased equipment was the same as the purchase price option).

In the instant case, Mrs. McElroy was required to make a large down payment that was described as capitalized cost reduction. This

amount was included in the total of payments and was not in any way refundable. Like the agreements in the *Puckett* case, the Vehicle Agreement provided for a large payment at the beginning of the contract, creating the economic reality that Mrs. McElroy would have to exercise the option to purchase the Explorer in order not to lose more than $9,000.00.

In *In re Bevis Co., Inc.*, 201 B.R. 923 (Bankr. S.D. Ohio 1996), the court held that two tests are used to determine whether an option purchase price is nominal.

> The first test compares the option price to the original cost of the leased equipment. . . .
>
> The second test compares the option price to the fair market value at the time of exercise of the option.

Id. at 926-27. In *Bevis*, the bankruptcy court found that a purchase price equal to 10% of the original cost of the equipment and a mere 7% of the value at the end of the lease was nominal. The court found that the purchase price with "a percentage this low has been sufficient to establish that the consideration required was nominal." *Id*. at 926.

In the present case, the purchase price is equal to approximately 3.5% of the original price of the Explorer and approximately 5% of the fair market value of a ten-year old Explorer. As a consequence, the purchase price in the Vehicle Agreement is nominal under both tests. Thus, the transaction covered by the Vehicle Agreement creates a security interest, as set forth in O.R.C. § 1301.01(KK)(2)(d).

IV. CONCLUSION

Because the Vehicle Agreement is a security interest rather than a true lease, Debtors have properly characterized the debt owed to Manor as a secured claim. As a consequence, the Objection to Confirmation will be overruled. An appropriate order will follow.

# # #

IT IS SO ORDERED.

Kay Woods

Honorable Kay Woods
United States Bankruptcy Judge

Dated: July 22, 2009
01:58:38 PM

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO

IN RE:	*	**CASE NUMBER 09-41366**
DAMOND MARCELL McELROY and LILLY MAE McELROY,	*	**CHAPTER 13**
	*	**HONORABLE KAY WOODS**
Debtors.	*	

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ORDER OVERRULING OBJECTION OF MANOR INSURANCE AGENCY, INC. TO CONFIRMATION OF DEBTORS' CHAPTER 13 PLAN

****

This cause is before the Court on Objection to Confirmation of the Chapter 13 Plan ("Objection to Confirmation") filed by Manor Insurance Agency, Inc. ("Manor") on May 12, 2009. Debtors Damond Marcell McElroy and Lilly Mae McElroy ("Mrs. McElroy") (collectively, "Debtors") filed a chapter 13 plan that listed "Manor Insurance" as having a secured claim in the amount of $5,000.00 (as the value of the security with no unsecured amount) at an interest rate of 4.25%.

The parties agree that the debt to Manor arose from an agreement between Manor and Mrs. McElroy regarding a 2002 Ford Explorer ("Vehicle Agreement"). The question before the Court is whether such debt was based on a true lease or disguised security agreement.

For the reasons set forth in this Court's Memorandum Opinion entered this date, the Court finds that (i) the Vehicle Agreement is a security interest rather than a true lease, and (ii) Debtors have properly characterized the debt owed to Manor as a secured claim. As a consequence, the Objection to Confirmation is hereby be overruled.

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