

In the United States Bankruptcy Court

for the Northern District of Iowa

J.E. ADAMS INDUSTRIES INC.
Debtor(s).

Bankruptcy No. 98-00167-C
Chapter 11

ORDER RE MOTION TO DETERMINE SECURED STATUS

On April 23, 1999, the above-captioned matter came on for hearing on a motion filed by Banc One to determine the status of certain equipment. Debtor appeared by Attorney Thomas Fiegen. Banc One appeared by Attorney Thomas McCuskey. The Unsecured Creditors' Committee appeared by Dan Childers. Evidence was presented and the Court took the matter under advisement. The time for filing briefs has now expired and this matter is ready for determination. This is a core proceeding pursuant to 28 U.S.C. §157(b)(2)(B) and (K).

STATEMENT OF THE CASE

J.E. Adams Industries, Ltd. (Debtor) filed a voluntary petition under Chapter 11 of the Bankruptcy Code on January 21, 1998. Debtor manufactures car wash components, custom machine parts, as well as fittings and cooling fans. Banc One (f/k/a NBD Equipment Finance, Inc.) is a lease and finance company. Over a period of time, Debtor and Banc One entered into six leases involving machines used in Debtor's business operations. The issue for determination is whether these documents are true leases or disguised security interests.

FINDINGS OF FACT

The first lease was entered into by Debtor and Banc One on March 14, 1994. The second lease was executed on April 24, 1994. The first lease involves a hydraulic shear and the second involves computer equipment. Both leases give Debtor an option to purchase the equipment for \$1 at the end of a 60 month payment term. While both leases were initially at issue, the parties now agree that they are security interests under existing Indiana law. Thus, four leases remain in controversy. The property in all four leases involves machines used in the manufacturing process. All machines were appraised and their fair market value was determined as of April 22, 1999. Each lease contains an option to purchase clause. For reference, the relevant uncontested information concerning these leases is set out in Attachment "A".

The Bankruptcy Code does not define the term "lease". It defines security interest as a "lien created by agreement". 11 U.S.C. §101(51). The legislative history of this section establishes that the Bankruptcy Code defers to applicable State or local law in making the determination whether a lease constitutes a security interest. In re Peacock, 6 B.R. 922, 924 (Bankr. N.D. Tex. 1980); In re Welter, No. 92-31850XF, slip op. at 11 (Bankr. N.D. Iowa, March 19, 1993).

All six leases were executed using the same lease form. Paragraph 18 of the leases provides that "This agreement shall be governed by the laws of the State of Indiana." Both Debtor and Banc One agree that interpretation of these leases requires an application of existing Indiana law.

The present applicable Indiana law came into existence on July 1, 1991 when Indiana Code sec.26-1-1-201 (37) was amended. It states that:

(37) "Security interest" means an interest in personal property or fixtures which secures payment or performance of an obligation. The retention or reservation of title by a seller of goods notwithstanding shipment or delivery to the buyer (IC 26-1-2-401) is limited in effect to a reservation of a security interest.

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 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.

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.

For purposes of this subsection:

- (x) 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;

(y) "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; and

(z) "Present value" means the amount as of a date certain of one (1) or more sums payable in the future, discounted to the date certain. The discount is determined by the interest rate specified by the parties if the rate is not manifestly unreasonable at the time the transaction is entered into. Otherwise, the discount is determined by a commercially reasonable rate that takes into account the facts and circumstances of each case at the time the transaction was entered into.

Indiana Code §26-1-1-201(37).

The language of the Indiana statute is similar, if not identical, to the Uniform Commercial Code language of section 1-201(37) in effect in Iowa and Minnesota as discussed by this Court in In re Bielenberg, 97-03063-S, slip op. at 6 (Bankr. N.D. Iowa, Jan. 26, 1998). There is some Indiana authority predating the passage of this statute which discusses the issues in question. McEntire v. Indiana Nat'l. Bank, 471 N.E.2d 1216 (Ind. Ct. App. 1984); Morris v. Lyons Capitol Resources, Inc., 510 N.E.2d 221 (Ind. Ct. App. 1987); Matter of Marhoefer Packing Co., Inc., 674 F.2d 1139 (7th Cir. 1982). The only case law discussing interpretation of the present Code section under Indiana law consists of two cases from the Indiana Tax Court. Kimco Leasing, Inc. v. State Board of Tax Commissioners, 622 N.E.2d 590 (Ind. Tax Ct. 1993); Kimco Leasing, Inc. v. State Board of Tax Commissioners, 656 N.E.2d 1208 (Ind. Tax Ct. 1995). The analysis of the statute adopted by the Indiana Tax Court, in general terms, is identical to that utilized by this Court in analyzing the same Code provision under Iowa and Minnesota law in Bielenberg. The Indiana Court states in Kimco II:

[T]he court finds that I.C. 26-1-1-201(37) sets forth two different tests for determining whether a lease is a true lease or a disguised security interest.

Under the first test, which may be characterized as a "bright line" test, a lease creates a security interest as a matter of law if: 1) the lessee is obligated to perform for the full length of the lease without being able to voluntarily terminate it, and 2) one of four enumerated terms are present.

Kimco II, 656 N.E.2d at 1217 (citations omitted).

All four leases in question have identical preprinted language. Under these leases, J.E. Adams Industries has no right to voluntarily terminate the leases before the end of the lease term. Paragraph 3 of the leases states that:

3. Non-Cancellable Lease. THIS IS A NON-CANCELLABLE LEASE. When Lessee signs and delivers a certificate of acceptance for the Equipment, its obligations to pay all rent and other amounts when due for the equipment and otherwise to perform as required under the

lease are unconditional, irrevocable, and independent. These obligations are not subject to cancellation, termination, modification, repudiation, excuse or substitution by Lessee. Lessee is not entitled to any abatement, reduction, offset, defense or counterclaim with respect to these obligations for any reason whatsoever, whether arising out of default or other claims against Lessor or the manufacturer or supplier of the Equipment, defects in or damage to the Equipment, its loss or destruction or otherwise.

Lease Documents, paragraph 3.

Therefore, J.E. Adams Industries' leases satisfy the first part of the test known under Indiana law as the "bright line" test.

Under the second part of the "bright line" test, this Court must determine whether J.E. Adams Industries' leases satisfy one of the four alternative terms under Ind. Code §26-1-1-2-1(37). These are:

- (1) the original term of the lease must be equal to or greater than the remaining life of the goods;
- (2) the lessee must be bound to renew the lease for the remaining economic life of the goods or must be 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 nominal additional consideration upon compliance with the lease agreement; or
- (4) the lessee must have the option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

Kimco II, 656 N.E.2d at 1217.

The appraisal performed on the machines establishes that at the end of the present lease period, there will be substantial economic life remaining in this equipment. Therefore, these leases do not satisfy the first term. Second, the leases allow for renewal. Paragraph 15 of the leases provides that:

15. Renewal. If the Equipment is not delivered to Lessor at the termination hereof in accordance with paragraph 6, then this Lease shall renew from month to month upon the same terms and conditions, subject to the right of Lessor or Lessee to terminate the renewed Lease on 30 days written notice, in which event, the Equipment shall immediately be returned to Lessor. No other renewal shall exist except and unless a separate written agreement is entered into between Lessor and Lessee.

Lease Documents, paragraph 15.

While the leases can be renewed under this provision, they contain no language which requires the lessee to renew. While the leases may be extended from month-to-month, there is nothing in the leases which requires the lessee to extend the lease for an indefinite period during which the remaining economic life of the property would be exhausted. Thus, the second term is not satisfied by the terms of these leases.

The third term is satisfied if the lessee has an option to renew the lease for the remaining economic life of the goods for no consideration or nominal consideration. The terms of these leases are for specific periods of time. The only renewal language is that contained in paragraph 15. This renewal option does not contemplate an extension for the remaining economic life of the property. The language of this paragraph reflects that the terms would automatically renew under the same conditions as the lease on a month-to-

month basis. Therefore, this term is not satisfied because the leases do not provide for an option to renew for an extended period of time during which the economic life of the goods would be exhausted for no consideration or for a nominal consideration.

The final term of this Code section is satisfied if the lessee has an option to become the owner of the goods for no additional consideration or a nominal consideration upon compliance with the lease agreement. While the parties do not dispute the Court's resolution of the prior three terms, the parties differ on the analysis to be provided to this term. This term speaks in the alternative. The first alternative allows a purchase for no additional consideration and the second is for a "nominal consideration". The documents do not allow the property to be purchased for no additional consideration. Therefore, the Court must focus on the alternative which speaks in terms of a nominal consideration. This Court previously made the determination of nominality based upon two tests. The first test requires a comparison of the option price as a percentage of the original purchase price. The Court in Indiana refers to this relationship as the "economic realities" test. This Court also considered the relationship of the option price as a percentage of the fair market value. The Indiana Court refers to this test as the "nominal consideration" test. This Court has used both the economic realities test and the nominal consideration test to evaluate nominality. Bielenberg, No. 97-03063-S, slip op. at 7.

The nominal consideration test used by the Indiana Court is identical to that used by this Court in its analysis in Bielenberg. As set out more fully hereafter, a purchase option price of more than 50% of the projected fair market value is a strong indicator of more than a nominal price. However, the Court's application of the economic realities test is different than that stated in Indiana. The Indiana Court in Kimco I stated that an option price of less than 25% of the list price was evidence of a security agreement. This Court stated in Bielenberg, applying White & Sommers, that where the purchase option was greater than 10% of the fair market value, this was a showing that a true lease existed. These are, in reality, the same tests but are stated from different perspectives. They can be reconciled by stating that, under the Bielenberg test, a ratio of more than 10% indicates a true lease. While under Kimco I, a ratio of more than 25% indicates a true lease. Alternatively, it can be stated that under Bielenberg a ratio of less than 10% indicates a security interest while in Kimco I an option price ratio of less than 25% indicates a security interest.

The Indiana Tax Court used both tests prior to the change in the statute. Now, however, the court appears to rely primarily on the nominal consideration test to evaluate whether or not the option can be purchased for nominal consideration under the fourth term of the statute. The Court held:

The amended version of I.C. 26-1-1-201(37) instructs that "[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." In determining whether additional consideration is nominal, courts have continued to utilize the "nominal consideration" test described above. As already explained, however, Kimco does not satisfy the "nominal consideration" test. Consequently, Kimco's leases are not security interests under the "bright line" test.

Kimco II, 656 N.E.2d at 1217 (citations omitted).

Therefore, while this Court has utilized both the nominal consideration test and the economic realities test in evaluating whether goods may be purchased for a nominal consideration, the Indiana Court limits itself primarily to the nominal consideration test, though it seems to continue to recognize the economic realities test as a secondary test. The Court stated in Kimco I that:

The "economic realities" test is a secondary test for the court's consideration which shows the relationship of the option price to the list price. Morris, 510 N.E.2d at 224, n.3 (citing McEntire, 471 N.E.2d at 1222). The McEntire and Morris courts stated an option price less than 25 percent of the list price constituted evidence of a security agreement.

Kimco I, 622 N.E.2d at 594. It is fair to state that this distinction does not skew the overall analysis in any significant way. For reasons set out hereafter, however, it does impact the manner in which Debtor has applied this test.

This Court has stated in applying the nominal consideration test that a purchase option price of less than 50% of the projected fair market value at the option date is evidence of nominality while a figure over 50% should be considered more than a nominal price. The Indiana Courts have not expressly endorsed this 50% figure since the Code change in 1991. However, they recognize the nominal consideration test and state that: "We can find [the option price] 'nominal' only if it is insubstantial in relation to the fair market value . . . at the time the option would have been exercised." McEntire v. Indiana Nat'l. Bank, 471 N.E.2d 1216, 1221 (Ind. Ct. App. 1984). The Indiana Courts have also evaluated nominal consideration as follows: "Because the option in this case entitled the [lessees] to purchase the equipment at its fair market value, the option price cannot be held to be insubstantial in relation to the fair market value at the time the option would have arisen." Morris v. Lyons Capitol Resources, Inc., 510 N.E.2d 221, 222 (Ind. Ct. App. 1987). In Morris, the Indiana Court cited favorably the case of Marhoefer Packing Co., Inc., 674 F.2d 1139 (7th Cir. 1982). The Marhoefer court held that:

While it is difficult to state any bright line percentage test for determining when an option price could properly be considered nominal as compared to the fair market value of the leased goods, an option price of almost ten thousand dollars, which amounts to fifty percent of the fair market value, is not nominal by any standard.

Furthermore, in determining whether an option price is nominal, the proper figure to compare it with is not the actual fair market value of the leased goods at the time the option arises, but their fair market value at that time as anticipated by the parties when the lease is signed.

Marhoefer, 675 F.2d at 1144-45.

This Court concludes that in all material respects, the Indiana Courts analyze this statute in a manner consistent with this Court's analysis in Bielenberg. In applying the "nominal consideration" test, the standard percentage for dividing nominal and non-nominal consideration is 50%. Debtor, in its brief at page 7, however, uses a different analysis. Debtor states:

However, the Indiana Tax Court determined that consideration is nominal if it is less than twenty-five (25%) percent of the original acquisition price. *Id.*, Kimco, 656 N.E.2d at 1215. The option price under all four contested NBD instruments is less than twenty-five (25%) percent!

Debtor's Brief, page 7.

This analysis misinterprets Kimco. The reference made by Debtor in its brief is to the economic realities test and not the nominal consideration test. It is correct that the Indiana Court, in applying the economic realities test, states that a purchase option price of less than 25% of the original purchase price constitutes evidence of a security interest. Kimco II, 656 N.E.2d at 1215. However, as this Court has indicated, the economic realities test is largely a secondary test when used by the Indiana Courts. In any event, it is inappropriate to transpose the 25% figure utilized in the economic realities test to the nominal consideration test. The correct percentage utilized by the Indiana Courts in applying the nominal consideration test is 50%. The error in this analysis is significant. See Attachment "A". Debtor concludes that since all of the figures in the economic realities test column are less than 25%, this is conclusive evidence of a security interest. This is incorrect in several respects. First, this is merely a secondary test. Second, the test is not conclusive but some evidence of a security interest. Finally, the appropriate column to examine is the "nominal consideration" test column which utilizes 50% as a benchmark and not 25%.

The Court will apply the above considerations to each of the four remaining lease documents. The first lease (Lease No. 3) has a nominal consideration test ratio of 54.4%. This satisfies the criteria used by prior Indiana Courts. Therefore, the fourth alternative term is not satisfied because Debtor cannot become the owner of the machinery for a nominal additional consideration. However, the Court must consider one additional factor. The fair market value used in this determination was based on a recent appraisal. In determining whether an option price is nominal, the Court must look at the present fair market value as anticipated by the parties when the lease was signed. Here, there is some evidence that the market for these machines is depressed. It is fair to conclude that this was not anticipated when the leases were executed. However, the precise extent of this reduction in value is not specified and the ratio is sufficiently more than 50% to convince the Court that under the nominal consideration test, the fourth term has not been established.

Under the Indiana Code, if none of the four terms establishes, ipso facto, a security interest, the Court must turn to the new point of emphasis under this Code section. This point of emphasis is a determination of whether a substantial reversionary interest exists. If no substantial reversionary interest exists, a security interest may exist despite the earlier analysis. If there is a meaningful reversionary interest - either an upside right or a downside risk - a lease and not a security interest exists. The present fair market value of the machine in this lease is approximately \$45,000. Under any applicable test, this constitutes a substantial residual value to the lessor. Because of this residual interest, there exists a meaningful upside right to the lessor. This constitutes a reversionary interest of substantial value and, therefore, requires the conclusion that as to Lease No. 3 the parties executed a lease and not a security agreement. As this is a lease, Debtor has no ownership interest.

Lease No. 4 has an option price of \$46,818.96 and a present fair market value of \$45,000. Under the nominal consideration test, this constitutes a ratio of 104%. It is not necessary to examine this lease at any great length. Assuming the same analysis as previously rendered on Lease No. 3, it is abundantly clear that the nominal consideration test under the fourth alternative is not satisfied and that a substantial reversionary right exists in the lessor. There is no doubt that as to Lease No. 4, the parties executed a lease and not a security agreement. Again, as this document constitutes a lease, Debtor has no ownership interest.

Lease No. 5 has an option price of \$50,487.44 and a present appraised value of \$105,000. This lease consists of two separate items of machinery. However, for purposes of this lease, they are analyzed together. Based on the appraised value and option price, the nominal consideration percentage ratio is 48.1%. Under the analysis previously discussed, a figure of less than 50% of the projected fair market value at the option date is an indicator of nominal consideration. The 48.1% figure may, under normal circumstances, be given closer scrutiny since the 50% figure is not an absolute. However, as discussed previously in reference to Lease No. 3, the Court must stand at the front of the lease and consider the fair market value as anticipated by the parties when the lease was executed. There is evidence that the market is depressed for this type of machinery. While the amount is uncertain, it is clear that there is some reduction in value over what may well have been anticipated at the time of the execution of the leases. Incorporating any reduction based on a depressed market drops the ratio to substantially less than 50%. This is sufficient to convince the Court that Debtor has the option to purchase these machines for a nominal additional consideration. As this satisfies the fourth term, the criteria required under the Indiana statute are established and the transaction involving Lease No. 5 constitutes, ipso facto, a security interest as defined by Indiana Code sec.26-1-1-201(37).

Lease No. 6 involves an option price of \$52,500 on a present appraised fair market value of \$175,000. This is a ratio of 30% under the nominal consideration test. Again, the Court feels that this ratio is so low that no significant analysis is necessary. Considering the benchmark of 50%, the requisite terms under the Indiana statute are satisfied and this transaction also constitutes a security interest as defined by the Indiana statute.

In summary, the parties have agreed among themselves that Leases No. 1 and 2 are security interests as defined by the Indiana statute. As to Leases No. 3 and 4, the evidence establishes that the option price compared to the projected fair market value is in excess of 50% and is, therefore, not a nominal sum. Additionally, there does exist a reversionary interest of substantial value and, therefore, this Court must conclude that Leases No. 3 and 4 are true leases and not security agreements. As to Leases No. 5 and 6, Debtor has established that the option price of the percentage of the fair market value is less than the 50% benchmark. The record establishes that Debtor, therefore, had an option to become the owner of the goods for a nominal consideration upon compliance with the lease agreement. The required criteria are established and the transactions involving Leases No. 5 and 6 constitute security interests as defined by Indiana law.

ALLOWED CLAIM/LATE FEES/ATTORNEY'S FEES

Debtor has additionally argued issues concerning the claim of NBD as well as interest charges and attorney's fees claimed by counsel for NBD. In this regard, the Court concludes that counsel for NBD should submit to the Court an itemized fee application. Additionally, the Court concludes that supplemental briefs and oral argument should be held on the remainder of these issues. Thereafter, the Court will make a determination as to the appropriateness of attorney's fees as well as interest and/or penalties. Both parties are to submit supplemental briefs no later than five days prior to oral argument.

WHEREFORE, it is this Court's determination that Leases No. 1 and 2 are security interests as agreed by the parties and as defined by Indiana law.

FURTHER, it is the determination of this Court that Leases No. 3 and 4 are true leases and not security interests for the reasons set forth in this opinion.

FURTHER, it is the determination of this Court that Leases No. 5 and 6 are security interests as defined by Indiana law for the reasons set forth in this opinion.

FURTHER, the final issues involving interest, penalty and attorney's fees of NBD will be set for further oral argument by separate order as previously discussed herein.

SO ORDERED this 26th day of May, 1999.

Paul J. Kilburg
U.S. Bankruptcy Judge

ATTACHMENT "A"

No.	Lease	Term of Lease	Price	Price	Appraisal/ Fair Market Value	Economic Realities Test Option Price % of Purchase	Nominal Consideration Test Option Price % of Fair Market Value	
3	Miyano ANC-45S 5-Axis -	June 30, 1994	60 months	\$111,250.00	\$24,475.00	\$ 45,000.00	22.0%	54.4%

	S/N NR450133							
4	Miyano ANC-35 - S/N NR350131	June 24, 1994	60 months	\$195,079.00	\$46,818.96	\$ 45,000.00	24.0%	104.0%
5	Miyano CNC, ANC-35 - S/N NR350093 Miyano ANC-45-S CNC - S/N AN450117	August 4, 1994	60 months	\$210,364.33	\$50,487.44	\$105,000.00 (\$45k/\$60k)	24.0%	48.1%
6	Tornos Screw Machine SAS16DC - S/N T59441	December 1, 1994	72 months	\$348,645.00	\$52,500.00	\$175,000.00	15.1%	30.0%