

IN THE UNITED STATES BANKRUPTCY COURT
 FOR THE
 SOUTHERN DISTRICT OF GEORGIA
 Augusta Division

IN RE:)	Chapter 11 Case
)	Number <u>95-12311</u>
MCGOWEN PRINTING AND OFFSET CO., INC.)	
)	
Debtor)	
)	
TEXTRON FINANCIAL CORPORATION)	FILED
)	at 4 O'clock & 53 min. P.M.
Movant)	Date: 8-9-96
)	
vs.)	
)	
MCGOWEN PRINTING AND OFFSET CO., INC.)	
)	
Respondent)	

ORDER

Textron Financial Corporation (hereinafter "Textron") filed Motions to Modify the Automatic Stay, for Abandonment of Property and to Require Segregation of and Accounting for Cash Collateral against the debtor in possession, McGowen Printing and Offset Co., Inc., (hereinafter "McGowen"). Based upon the evidence presented at a consolidated hearing, the motions are denied.

On January 17, 1991, McGowen entered into a financing

arrangement with Fleet Credit Corporation (hereinafter "Fleet"), a Rhode Island Corporation. Pursuant to this financing arrangement, the parties executed documents titled Master Equipment Lease Agreement (hereinafter "Master Lease"), Purchase Option Rider with Automatic Renewal (hereinafter "Purchase Option"), True Lease Schedule (hereinafter "Schedule"), Additional Security Agreement, Secured Promissory Note (hereinafter "Note"), and a Master Security Agreement to secure payment of the Note.

The Master Lease recited the following general terms which controlled all leasing arrangements between the parties.

1. Title of the equipment remained with Fleet throughout the lease period.
2. Fleet disclaimed all implied and express warranties regarding the condition or suitability of the equipment.
3. McGowen assumes the risk of liability and agreed to indemnify Fleet for any and all liabilities, losses and claims arising from McGowen's use of the equipment.
4. McGowen is liable for all taxes due on the equipment.
5. McGowen was to pay Fleet a security deposit which would be returned to McGowen at the end of the lease term or applied to any outstanding amounts due to Fleet in the event of a default.
6. McGowen assumed all maintenance expenses and the risk of loss or damage to the equipment.
7. McGowen was to procure and maintain insurance on the equipment.
8. The lease was to be construed in accordance with

the laws of Rhode Island.

The Purchase Option provided that:

So long as no Event of Default has occurred and is continuing under the Lease and upon not less than 90 days' prior written notice, Lessee shall have the right, upon expiration of the Lease Term of the above-referenced Lease (the "Initial Term"), to purchase all, but not less than all, of Lessor's right, title and interest in and to the Equipment for a purchase price equal to (a) the greater of (i) the Fair Market Value of the Equipment (hereinafter defined) as of the end of the Initial Term, or (ii) 20% of the Acquisition Cost of the Equipment plus (b) any sales, use, property or excise taxes on or measured by such sale and any other expenses of transfer (all of the foregoing being collectively referred to herein as the "Purchase Price").

The Purchase Option further provided that:

If for any reason whatsoever, the Lessee does not purchase the Equipment at the end of the Initial Term in accordance with this Rider, the Lease Term of the Equipment shall automatically and without further action on the part of the Lessor or Lessee be extended for an additional consecutive term of 12 months ("the extended Term") at a monthly rental of \$9,250.82 (the "Extended Term Rental") with each Extended Term Rental being due and payable on the same day of each month of the Extended Term. At the end of such Extended Term, the Lessee shall be obligated to return the Equipment to the Lessor in accordance with the terms of the Lease; provided, however, that if Lessee has executed any other Purchase Option Rider with Lessor with respect to the Equipment, such Purchase Option Rider shall apply, and the purchase option contained therein shall be exercisable at the end, and only at the end, of the Extended Term.

The Schedule listed the equipment to be leased by McGowen and provided for 84 monthly payments of \$8,183.16. To accept delivery

of the equipment, McGowen signed Acceptance Certificate Number 1 on February 1, 1991 (hereinafter "Certificate 1"), and Acceptance Certificate Number 2 on September 20, 1991 (hereinafter "Certificate 2"). Certificate 1 described an Itek 3985 Two Color Press with Trade 1250 Tray and T-51 with 84 monthly payments of \$693.59. Certificate 2 described a New Bacher Exposure Unit and Omega II, Omega II-ADD, Omega II Cover Feeder, Omega Hand Feeder II, and Used No. 4 Color 19 x 25 ½ Heidelberg with 84 monthly payments of \$7,489.57. To further secure payment of the amounts due under the Schedule, McGowen delivered the Additional Security Agreement, granting to Fleet a security interest in:

All machinery, equipment, furniture, furnishings, tools, tooling, fixtures and accessories, and all inventory, accounts receivable, instruments, contract rights and other rights to receive the payment of money, patent, chattel paper, licenses, leases and general intangibles, including all trade names and trade styles and all additions, accessions, modifications, improvements, replacements and substitutions thereto and therefore, whether now owned or hereinafter acquired, and the proceeds, products and income of any of the foregoing including insurance proceeds.

The Additional Security Agreement also provided that:

10. Notwithstanding anything contained herein to the contrary, the security interest in the collateral is limited to the first \$250,000.00.

Fleet duly recorded a financing statement to perfect this security interest on January 30, 1991.

On January 17, 1991, Fleet also loaned McGowen \$75,000.00 to purchase a Miller Two Color Offset Press with accessories, evidenced by the Note and secured by the Master Security Agreement. McGowen was to repay the Note in 84 monthly payments of \$1,209.00 with a final 85th payment of \$15,000.00. The Master Security Agreement granted Fleet a security interest in the purchased equipment, in any insurance proceeds covering the equipment, and in any security deposits made by McGowen to Fleet.

In January 1994, Fleet assigned all of its interest in the above-listed transactions to Textron. On December 29, 1995 McGowen filed for relief under Chapter 11. Textron asserts that McGowen owes it, as of the filing of the motions now under consideration, one pre-petition payment and one post-petition payment under Certificate No. 1, although McGowen disputes this deficiency. Parties agree that McGowen failed to make post petition payments on Certificate No. 2. McGowen has offered to make adequate protection payments of \$4,696.09 for all three financial arrangements, an amount equal to half of all monthly payments owed to Textron under the above described transactions.

At hearing, Textron introduced an appraisal report stating the following current forced liquidation values of the equipment covered by the transactions and also asserted the following pay-offs.

<u>Instrument</u>	<u>Liquidation Value</u>	<u>Pay-off Balance</u>
Certificate 1	\$35,000.00	\$24,331.79
Certificate 2	\$283,000.00	\$347,652.96
Note	\$25,000.00	\$38,310.94

Although no direct evidence of the expected useful life of the equipment was introduced, McGowen's accountant testified that McGowen was depreciating the equipment over 11 years according to generally accepted accounting principles.

Textron asserts that the financing arrangements between McGowen and Textron under the Master Lease and Certificate 1 and 2 constitute equipment leases, which leases McGowen must either reject and return the equipment or accept and cure all arrearages and continue to make post petition payments as they become due. 11 U.S.C. §365(d)(2).¹ McGowen asserts that the financing arrangements are security agreements disguised as leases, and that they are therefore not subject to the provisions of §365.

The Master Lease, Certificate 1 and Certificate 2 all specify that Rhode Island law controls the interpretation and implementation of the documents. Whether Rhode Island law should apply in the

¹11 U.S.C. §365(d)(2) provides:
In a case under chapter 9, 11, 12, or 13 of this title [11], the trustee may assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor at any time before the confirmation of a plan but the court, on request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease.

instant case requires an analysis of Georgia conflict of law rules. United Counties Trust Co. v. Mack Lum, Inc., 643 F.2d 1140 (5th Cir. 1980) (A federal court should apply the choice of law provision of the state in which the court sits.) Under Georgia law, ". . . when a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such state or nation shall govern their rights and duties." Official Code of Georgia Annotated (O.C.G.A.) §11-1-105(1). Because Fleet, the original lessor under the agreement, is a Rhode Island corporation with a Rhode Island business address, these transactions bear a reasonable relation to that state, and the Georgia choice of law provision providing for the application of Rhode Island law controls.

I. THE MASTER LEASE AND CERTIFICATES 1 AND 2 CREATE SECURITY INTERESTS AND NOT TRUE LEASES.

Rhode Island's adoption of the Uniform Commercial Code (U.C.C.), defines a lease as "...a transfer of the right to possession and use of goods for a term in return for consideration, but a sale, including a sale on approval or a sale or return, or retention or creation of a security interest is not a lease." Rhode Island General laws (R.I.Gen. Laws 1956) §6A-2.1-103(j). Rhode Island's commercial code provides guidelines to determine whether a financing arrangement is a true lease or a security agreement.

R.I.Gen. Laws 1956 §6A-1-201(37)². Although Rhode Island revised

²R.I. Gen. Laws 1956 §6A-1-201(37) provides:
"Security Interest" means an interest in personal property or fixtures which secures payment or performance of an obligation. ... Unless a lease or consignment is intended as security, reservation of title thereunder is not a "security interest", but a consignment is in any event subject to the provisions on consignment sales (§6A-2-326).

(1) 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 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.

(2) 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 the risk of loss of the goods, or agrees to pay taxes, insurance, filing, or registration fees, or service or maintenance costs with respect to the goods;

(c) The lessee has an option to renew the lease or 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

§6A-1-201(37) subsequent to the effective date of the transactions at issue, the revision merely clarified the existing law and did not affect the parties substantive rights. See, Woodson v. Ford Motor Credit Co. (In re Cole), 114 B.R. 278 (N.D. Okl. 1990). I will therefore apply the revised statute in this case.

Section 6A-1-201(37) provides that whether a transaction constitutes a security interest or a lease is determined by the particular facts of a case. The statute includes a per-se test for finding a security interest and a list of factors which may, but do not automatically, indicate a security agreement. If a transaction fits the elements of the per-se rule, then the court's inquiry ends.

the option is to be performed.

(3) For purposes of this subsection (37):

(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; and

(c) "Present value" means the amount as of a date certain of one 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 unreasonably 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.

However, if a particular set of circumstances does not fit within the per-se rule, the court must analyze all of the facts of the particular case to determine whether the transaction is a lease or a security agreement.

To constitute a security interest as a matter of law under the Rhode Island statute the "rent" paid by the lessee must continue for the entire term of the lease without the lessee holding an option to terminate the payments, and one of the four factors listed in subsections (a) - (d) of §6A-1-207(37) must be present. In the instant case, none of the four factors apply. The debtor is depreciating the equipment over 11 years and the term of the lease, even extended is for 8 years. The original term of the lease is not equal to or greater than the remaining economic life of the goods. McGowen is not bound to renew the lease for the remaining economic life of the goods and is not bound to become the owner of the goods. McGowen does not have the option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal consideration. McGowen does not have the option to purchase the goods for no additional consideration or for nominal additional consideration. Therefore, the instant transaction is not a security agreement as a matter of law under the existing Rhode Island statute.

Subsection (2) lists factors which do not automatically indicate a security interest, but which are relevant in determining

the status of the transaction based upon the facts of the case. In addition to the five factors listed in §6A-1-201(37)(2)(a-e) (note 3), courts also analyze the following additional factors to determine whether a transaction creates a security interest or a lease:

1. Whether the lessee accumulates equity in the property; See, Western Enter., Inc. v. Arctic Office Mach., Inc., 667 P.2d 1232 (Alaska 1983);
2. Whether the lessee is economically compelled to purchase the assets; See, American Way Rentals v. Fogelsong (In re Fogelsong), 88 B.R. 194 (Bankr. C.D. Ill. 1988);
3. Whether the rent paid is as much or greater than the purchase price; Id.
4. Whether the lessee paid an additional security deposit or provided a guarantee or indemnity; See, Bill Swad Leasing Co. Stikes (In re Tillery), 571 F.2d 1361 (5th Cir. 1978); and
5. Whether the lessor charges the lessee a "termination payment" at the end of the lease if the lessee fails to purchase the collateral or renew the lease; See, Credit Car Leasing Corp. v. DeCresenzo, 525 N.Y.S.2d 492 (N.Y. City Civ. Ct. 1988).

Of the factors listed in §6A-1-201(37) and the additional judicially recognized factors, the following are indicative of true leases.

1. The option purchase price of the collateral is not nominal.
2. McGowen accumulates no equity in the collateral over the term of the lease.

In contrast, the following factors indicate security

agreements.

1. The total rent paid over the lease term and mandatory renewal period is greater than the purchase price of the collateral.
2. McGowen has assumed the risk of loss of the goods, and is liable for any taxes, insurance, filing, recording and registration fees, and service and maintenance on the equipment.
3. McGowen has the option to purchase the equipment after the initial lease term.
4. The lease required McGowen to provide a security deposit plus pledge additional collateral to secure the obligation.
5. The lessor charges a "termination payment" at the end of the initial lease period in the form of a mandatory charge of one year's rent at an inflated rate if McGowen fails to purchase the equipment.

Two additional factors, whether the increased renewal rental rate exceeds the fair market rent of the equipment and whether McGowen is economically compelled to purchase the equipment, bear analysis.

The annual rent for the equipment during the mandatory renewal period is \$12,811.92 greater than the annual rent due under the initial term.³ McGowen argues that the increased rent payments exceed the reasonably expected fair market rent because the equipment will be used and depreciated, which should decrease, not increase the fair market rent. To reflect the decrease in the value of the equipment resulting from the passage of time and the effect of use, McGowen is depreciating the equipment over an 11 year usable

³(\$9,250.82 x 12) - (\$8,183.16 x 12) = \$12,811.92

equivalent value adjusted for inflation of the initial payment of \$8,183.16, exceeds a fair market rental for the renewal term. It appears that the agreements may, as Textron indicates, take into consideration inflation in setting the new rental rate for the renewal term, but clearly fails to consider the depreciation of the equipment in setting the rate.

The final factor is whether McGowen is economically compelled to purchase the equipment at the end of the lease period. At the end of the initial 84 month period, McGowen will have paid \$687,385.44, and will have two options: 1) to renew the lease for another year at an inflated rate; or 2) to purchase the equipment for its fair market value or 20% of the initial acquisition cost ($\$507,640.00 \times 20\% = \$101,528.00$), whichever is greater. If McGowen chooses not to purchase the equipment, it is obligated to pay \$111,009.84 during the renewal period in addition to the \$687,385.44 it already paid. This payment is required even if McGowen does not use the equipment beyond the initial term. At the end of this renewal period, McGowen is left without any contractual right to either purchase the equipment or renew the lease at any rate. Under this option, McGowen is faced with paying a total of \$798,395.28 for equipment initially worth \$507,640.00 without the right to keep that equipment at the end of the renewal period. McGowen is economically compelled to purchase the equipment at the end of the initial period.

Although no single factor definitively determines whether these transactions constitute leases or security agreements, all of the circumstances surrounding the transactions establishes the transactions as security agreements disguised as leases. Therefore, McGowen is not required to either accept or reject the "unexpired leases" and may deal with its obligation to Textron as purchase money security agreements.

II. TEXTRON IS NOT ENTITLED TO RELIEF FROM THE AUTOMATIC STAY.

Textron moves for relief from the automatic stay under 11 U.S.C. §362(d)⁷, asserting that it lacks adequate protection of its security interest in the collateral because the Debtor continues to use the equipment in its business, thereby diminishing its value. Using Textron's figures regarding the value of the collateral and pay-off balances, the net equity in the equipment purchased under Certificate 1 is \$10,668.21, while Textron is undersecured under

⁷11 U.S.C. §362(d) provides in part pertinent to this case:
(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—
 (1) for cause, including the lack of adequate protection of an interest in property of such party in interest;
 (2) with respect to a stay of an act against property under subsection (a) of this section if—
 (A) the debtor does not have an equity in such property;
and
 (B) such property is not necessary to an effective reorganization; . . .

Certificate 2 and the Note by \$64,652.96 and \$13,310.94 respectively. I find that the 30% equity cushion in the equipment described in Certificate 1 adequately protects Textron's interest in that equipment. See, Pistole v. Mellor (In re Mellor), 734 F.2d 1396 (9th Cir. 1984). However, Textron is entitled to adequate protection of its security interest under the latter two instruments.

Adequate protection may take one of several forms under 11 U.S.C. §361⁸. McGowen has offered Textron adequate protection payments of \$4696.09 per month. Whether this amount adequately sustains Textron's security interest in Certificate 2 and the Note, requires an analysis of the equipment's rate of depreciation using two separate methods; 1) McGowen's eleven year straight-line

⁸11 U.S.C. §361 provides:

When adequate protection is required under section 362, 363, or 364 of this title of an interest of an entity in property, such adequate protection may be provided by—

(1) requiring the trustee to make a cash payment or periodic cash payments to such entity, to the extent that the stay under section 362 of this title, use, sale, or lease under section 363 of this title, or any grant of a lien under section 364 of this title results in a decrease in the value of such entity's interest in such property;

(2) providing to such entity an additional or replacement lien to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property; or

(3) granting such other relief, other than entitling such entity to compensation allowable under section 503(b)(1) of this title as an administrative expense, as will result in the realization by such entity of the indubitable equivalent of such entity's interest in such property.

depreciation method, and 2) extrapolating the rate of depreciation from the initial purchase price and the recent appraisal at a forced liquidation value. To calculate the straight-line monthly depreciation, divide the acquisition cost of the equipment (\$539,640.00) by 132 months (eleven years). To calculate the depreciation using the appraisal figures, divide the net decrease of value from the date of acquisition (\$539,640.00) to the appraisal date (\$308,000.00) by the number of months between McGowen's acquisition of the equipment and the appraisal. These methods revealed the following monthly rates of depreciation:

	<u>11 yr. straight-line</u>	<u>Appraisal</u>
Certificate 2	\$3520.00/month	\$3363.20/month
Note	<u>\$ 568.18/month</u>	<u>\$806.45/month</u>
Total	\$4088.18	\$4170.15

Under either method, McGowen's offer of adequate protection exceeds the rate of depreciation. I therefore find that monthly payments of \$4,696.09 will adequately protect Textron's interest in the collateral.

III. TEXTRON MAINTAINS NO SECURITY INTEREST OVER MCGOWEN'S ACCOUNTS RECEIVABLES AND THE PROCEEDS THEREOF ARE NOT TEXTRON'S CASH COLLATERAL.

Cash collateral under 11 U.S.C. §363(a)⁹ consists of any cash or cash equivalent in which a creditor retains a post-petition security interest under 11 U.S.C. §552(b)¹⁰. An account receivable is neither cash nor a cash equivalent, and is therefore not cash collateral. However, the cash proceeds derived from the prepetition accounts receivable are cash collateral to the extent that the accounts receivable are subject to Textron's security interest.

The Additional Security Agreement granted Textron a security interest in, inter alia, "...accounts receivable, ... and the proceeds, products and income of any of the foregoing... ." However, the agreement specifically limits the security interest "...to the first \$250,000.00." Textron argues that this statement

⁹11 U.S.C. §363(a) provides in part:

(a) In this section, "Cash collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property ... subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

¹⁰11 U.S.C. §552(b) provides:

(1)...[I]f the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the estate acquired before the commencement of the case and to proceeds, product, offspring, or profits of such property, then such security interest extends to such proceeds, product, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based upon the equities of the case, orders otherwise.

limits the security interest to the first \$250,000.00 of the collateral. McGowen asserts that this provision limits the additional security interest to the first \$250,000.00 of McGowen's liability secured by the Additional Security Agreement. McGowen further asserts that it has satisfied over \$250,000.00 of its liability to Textron, and therefore no further security interest exists covering the accounts receivable.

Because either interpretation is reasonable, the provision is ambiguous and subject to interpretation according to Rhode Island's rules of construction. Interpretations of ambiguous contract terms are questions of fact to be resolved by the trier of fact. Fryzel v. Domestic Credit Corp., 385 A.2d 663, 666 (1978). Furthermore, ambiguities in a contract are generally construed against the drafter of the document. Id. The contract at issue was drafted by Fleet and is set forth on Fleet's pre-printed forms, and therefore should be construed in favor of McGowen and against Textron, as successor in interest to Fleet. Resolving the ambiguity in favor of McGowen results in satisfaction of the security interest created under the Additional Security Agreement, because it is undisputed that McGowen has already paid over \$250,000.00 to Fleet and Textron. With no security interest covering the accounts receivable or their proceeds on the date of the bankruptcy filing, the proceeds are not Textron's cash collateral.

It is therefore ORDERED that Textron's motions to modify the

automatic stay, require abandonment of property and segregation of and accounting for cash collateral are DENIED;

Further ORDERED that McGowen shall immediately tender to Textron adequate protection payments of \$4,696.01 per month from the filing of this case.

JOHN S. DALIS
UNITED STATES BANKRUPTCY JUDGE

Dated at Augusta, Georgia
this 9th day of August, 1996