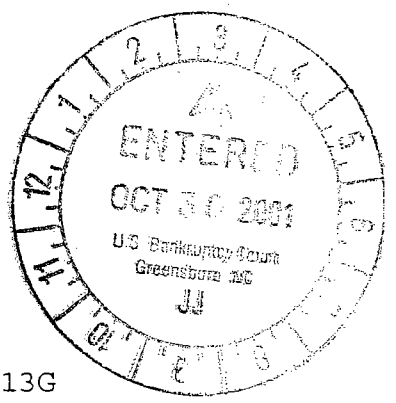

UNITED STATES BANKRUPTCY COURT
MIDDLE DISTRICT OF NORTH CAROLINA
GREENSBORO DIVISION

IN RE:	)	
	)	
Ledia Woods,	)	Case No. 01-11913C-13G
	)	
Debtor.	)	
	)	

AMENDED ORDER[1]

This case came before the court on October 10, 2001, for hearing upon a Motion to Compel Assumption or Rejection of Unexpired Lease filed by Greensboro Rental Systems, Inc., d/b/a ColorTyme. The contract referred to in the motion is entitled "Rental Purchase Agreement" and is dated July 27, 2000.[2] ColorTyme asserts that the contract is an executory contract and therefore subject to § 365 of the Bankruptcy Code. The Debtor and the Chapter 13 Trustee argue that the transaction between the Debtor and ColorTyme involved a purchase of the furniture referred to in the contract and that the contract is a disguised security agreement rather than an executory contract. Having considered the motion, the contract and the evidence offered at the hearing the court finds and concludes as follows:

1. Applicable law.

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[1]This amended order is issued to correct an omission that occurred on page 3 of the original order.

[2]The contract thus predates and is not subject to the amendments to Chapter 25 of the North Carolina Statutes which became effective on July 1, 2001.

As a general rule, the existence, nature and extent of a property interest is governed by state law. See Butner v. United States, 440 U.S. 48, 99 S.Ct. 914, 59 L.Ed.2d 136 (1976). This general rule is applicable where a bankruptcy court is called upon to determine whether a purported lease or consignment in actuality constitutes a security interest. See In re Powers, 983 F.2d 88, 90 (7th Cir. 1993). Therefore, in resolving the dispute involved in the present case, the court must be guided by the law of North Carolina, the place where the contract was signed and where the parties and the furniture referred to in the contract are located.

2. Statutory definition of "lease".

The Uniform Commercial Code as adopted in North Carolina 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." N.C.G.S. § 25-2A-103(1)(j). The transaction in the present case involves a transfer of the right to possession and use of household furniture for a term in return for consideration and on its face purports to be a lease. However, the contention by the Debtor and the Trustee that in actuality the transaction created a security interest requires an examination of the Uniform Commercial Code definition of a security interest which, in North Carolina, is found in N.C.G.S. § 25-1-201(37).

3. Statutory definition of "security interest".

Under the definition contained in G.S. § 25-1-201(37), a security interest is "an interest in personal property or fixtures which secures payment or performance of an obligation." Whether a transaction creates a lease or security interest "is determined by the facts of each case . . . ." However, subparagraph (a) of § 25-1-201(37) creates an exception to the basic direction that the determination should be made on the facts of each case by providing that, without making an overall examination of the facts, a lease must be treated as a security interest if any one of four elements specified in subparagraph (a) is present.[3]

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[3]The four elements specified in subparagraph (a) are:

(i) The original term of the lease is equal to or greater than the remaining economic life of the goods, or

(ii) The lessee is bound to renew the lease for the remaining economic life of the goods or is bound to become the owner of the goods, or

(iii) The lessee has an option to renew the lease for the remaining economic life of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement, or

(iv) The lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

If subparagraph (a) is not applicable to a transaction, then the statutory directive that the nature of the transaction "is determined by the facts of the particular case" is controlling. Subparagraph (b) of G.S. § 25-1-201(37) provides guidance for this determination to the extent of providing that a security interest is not created merely because it includes any of the five elements enumerated in subparagraph (b). Thus, the transaction does not create a security interest merely because (i) the present value of the consideration the lessee is obligated to pay the lessor for the right to possession and use of the goods is substantially equal to or is greater than the fair market value of the goods at the time the lease is entered into, (ii) the lessee assumes the risk of loss of the goods or agrees to pay taxes, insurance, filing, recording or registration fees, or service or maintenance calls with respect to the goods, (iii) the lessee has an option to renew the lease or to become the owner of the goods, (iv) the lessee has an option to renew the lease for a fixed rent that is equal to or greater than the reasonably predictable fair market value for the use of the

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Effective July 1, 2001, subparagraph (a) of G.S. § 25-1-201(37) was amended to provide expressly that the per se exceptions in subparagraph (a) are applicable only where the consideration to be paid by the lessee "is an obligation for the term of the lease not subject to termination by the lessee. . . ." According to one commentator, this language was added to § 1-201(37) "to make it clear that a terminable lease is not and cannot, as a matter of law, be a 'security interest.'" Barkley Clark, et al., "Rent-to-Own" Agreements in Bankruptcy: Sales or Leases?, 2 Am Bankr. Inst. L. Rev. 115, 133 (1994).

goods for the term of the renewal at the time the option is to be performed, or (v) the lessee has an option to become the owner of the goods for a fixed price that is equal to or greater than the reasonably predictable fair market value of the goods at the time the option is to be performed.

4. Application of the statutory definition.

Since the definition of a security interest focuses on the economics of the transaction, it is helpful to review the terms of the purported lease or rental agreement that bear upon the economics of the transaction. In the present case, the agreement is entitled "Rental Purchase Agreement" and contains a description of the "merchandise" that is the subject of the agreement, which consists of household furniture. The agreement specifies a rental term of one week and a total rental payment of $31.79, consisting of a "rental rate" of $29.99 plus sales tax of $1.80. The contract provides that at the end of such term, the Debtor may either (1) continue to rent the property by paying another rental payment before the end of the current term; or (2) terminate the contract by returning the furniture to ColorTyme. The contract specifically provides that the "rental property" remains the property of ColorTyme and that the Debtor may not sell, pledge, mortgage, pawn, encumber or otherwise dispose of the property unless ownership is transferred to the Debtor as provided in the contract. Transfer of ownership is dealt with in a paragraph entitled "Ownership Option"

which provides that the Debtor may acquire ownership by renewing the contract for 104 successive one-week terms and by making one "additional payment which shall be $254.32." This paragraph also provides that as of July 27, 2000, which is the inception of the agreement, the value of the rental property was $2,498.11. The contract states specifically that the Debtor is not obligated to renew the agreement and that the Debtor "may terminate this Agreement by immediately returning the property to the Owner or by not renewing this Agreement before the end of any rental period." However, this provision is amended by a later provision that provides that "I fully understand that there is a minimum of 3 months rental on this agreement and agree to pay $381.48 to COLORTYME which is equal to 3 months rent plus tax, if this agreement is terminated for any reason by Lessee or Lessor within the first 3 months of receipt of delivery."

In determining whether the agreement in the present case should be deemed a security agreement, the most critical of the contractual provisions of the agreement are the provisions permitting the Debtor to terminate at any time after the initial three-month term and to return the furniture with no further obligation. Although the North Carolina courts apparently have not addressed the issue, most courts that have done so have concluded that contracts containing such provisions do not involve a secured sale and, hence, do not constitute security agreements. See In re Powers, 983 F.2d 88 (7th

Cir. 1993); In re Marhoefer Packing Co., 674 F.2d 1139 (7th Cir. 1982); In re Frady, 141 B.R. 600 (Bankr. W.D.N.C. 1991); In re Huffman, 63 B.R. 737 (Bankr. N.D. Ga. 1986); Barkley Clark, et al., "Rent-To-Own" Agreements in Bankruptcy: Sales or Leases?, 2 Am. Bankr. Inst. L. Rev. 115, 124-133 (1994). These authorities emphasize that the statutory definition specifically provides that a security interest "secures payment or performance of an obligation" and that there is no obligation to secure under a contract that permits the lessee to terminate at any time and return the goods without any further payment or obligation. Hence, such a contract cannot constitute a security agreement. This point is succinctly stated by White & Summers: "If the 'lease' is terminable at the will of the lessee, and if upon return of the asset, there is no further obligation, the transaction cannot be a secured sale. That is true even if the apparent lease term continues for the entire economic life or if there is an option for nominal consideration." 1A James J. White & Robert S. Summers, Uniform Commercial Code 18 (3d ed. 1991).

5. Conclusion.

The contract in the present case clearly states that the furniture is and remains the property of ColorTyme unless ownership is acquired by the Debtor making 104 weekly payments plus the $254.32 option payment. However, Debtor's only payment obligation is to pay $381.48 over a period of three months. Thereafter the

Debtor has no obligation to retain the furniture or to make any further payments. The option to acquire the furniture is not related to the initial three-month term. Rather, the option to acquire the furniture arises only if the Debtor retains the property and makes weekly payments for 104 payments. Most significantly, however, the Debtor is not obligated to make such weekly payments or to retain the property. At any time after the initial three months the Debtor may return the furniture, in which event there is no further obligation to make payments. Based upon these terms and the fact that Debtor has no retention or payment obligations after the initial three months, the court concludes that the contract is a lease and not a security agreement. As such, the contract is subject to the requirements of § 365 of the Bankruptcy Code. Debtor therefore must assume or reject the contract. If the contract is rejected, Debtor no longer will be bound by the contract, but must return the furniture to ColorTyme. If Debtor elects to assume the contract, the requirements of § 365(b)(1) will have to be met if there has been a prepetition default. The time within which Debtor must make the election to assume or reject shall be extended until the date on which Debtor files her proposed plan of reorganization.

IT IS SO ORDERED.

This 30th day of October, 2001.

William L. Stocks

WILLIAM L. STOCKS
United States Bankruptcy Judge