

**United States Bankruptcy Court
District of New Mexico**

Document Verification

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UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEW MEXICO

In re:

FURRS SUPERMARKETS, INC.,
Debtor.

No. 11-01-10779 SA

FURRS SUPERMARKETS, INC.,
Plaintiff,

v.

Adv. No. 01-1160 S

FINOVA CAPITAL CORP.,
HELLER FINANCIAL, INC.,
and MDFC EQUIPMENT LEASING CORP.,
Defendants.

**MEMORANDUM OPINION ON CROSS MOTIONS
FOR SUMMARY JUDGMENT AND ORDER**

This matter is before the Court on the following two motions: 1) Motion for Summary Judgment by Plaintiff (docket 5), with supporting Memorandum (docket 6) and affidavit (docket 7), and the objections thereto by Defendant Heller Financial Leasing, Inc. (by Memorandum with attached exhibit and affidavit, docket 12) and the reply by Plaintiff (docket 22); and 2) Motion by Defendant Heller Financial Leasing, Inc. ("Heller")¹ for summary judgment (docket 25), with supporting Memorandum (docket 26) and affidavit (docket 27), and the response by Plaintiff (docket 28) with supporting affidavit

¹ It appears that the correct name for the defendant is Heller Financial Leasing, Inc., although the caption and the complaint identify "Heller Financial, Inc." Heller Financial Leasing, Inc. has responded to the complaint and has been treated as the party whose leases and other property interests are at stake.

(docket 29) and reply by Heller (docket 30) with Supplement to Reply that attaches selected portions of the Steven Mortensen deposition (docket 31).²

This adversary proceeding to determine validity of liens is a core proceeding. 28 U.S.C. § 157(b)(2)(A) and (K). Before the Court are cross motions for summary judgment, governed by Federal Bankruptcy Rule 7056. The Court must grant a motion for summary judgment:

if the pleadings, depositions, answers to interrogatories and admissions on file, together with affidavits ... show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.

Fed.R. Bankr. 7056(c). In deciding whether material factual issues exist, the Court must resolve all ambiguities and draw all reasonable inferences against the moving party. In re APB Online, Inc., 259 B.R. 812, 816 (Bankr. S.D. N.Y. 2001)(citing Matushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 587 (1986).)

PLAINTIFF'S MOTION

Plaintiff's Motion argues that the "leases" that it entered into with Heller are disguised secured financing transactions. First, citing In re Triplex Marine Maintenance,

² Defendant MDFC Equipment Leasing Corp. settled its dispute with the Debtor in Possession. See doc 1010 in the main case.

Inc., 258 B.R. 659, 667-70 (Bankr. E.D. Tx. 2000) and In re Kim, 232 B.R. 324, 330 (Bankr. E.D. Pa. 1999), Plaintiff argues that because the leases are noncancellable and bear certain other traits they satisfy a per se test that dictates that the leases are in fact secured transactions. Second, citing Triplex Marine and Banterra Bank v. Subway Leasing (In re Taylor), 209 B.R. 482, 486 (Bankr. S.D. Il. 1997), Plaintiff argues that under the "economic realities", the leases are disguised secured financing transactions.

HELLER'S MOTION

Heller argues, citing In re Marhoefer Packing Co., Inc., 674 F.2d 1139 (7th Cir. 1982), that the leases are true leases under Washington state law. Additionally, Heller disputes Debtor's assertion that it would not be feasible to satisfy the return conditions of the leases. Heller also disputes that debtor had no reasonable option under the lease other than to purchase the equipment at the end of the lease term and that the fact that a purchase option may be a "good deal" does not turn a true lease into a secured transaction. Heller also disputes facts regarding replacement costs claimed by plaintiff.

FACTS

1. The Heller Master Equipment Lease Agreement ("Lease") is attached as Exhibit A to Defendant Heller Financial Leasing, Inc.'s Memorandum in Opposition to Plaintiff's Motion for Summary Judgment (docket 12)³. This lease provides, in part:

1. ... Lessor requirements and conditions shall include ... documents to implement, perfect, or continue the perfection of Lessor's rights and remedies as owner and Lessor of the Equipment, including Uniform Commercial Code forms. Notwithstanding the execution delivery or filing of any instruments or documents, it is agreed that this transaction is a lease and is not intended as security. ...

2. Each lease is a non-cancellable net lease. ... Each lease is intended to constitute a true lease and not a sale of the related equipment. Title to the equipment will remain with lessor at all times. Lessee's interest in the equipment is limited to a leasehold.

...

9. ... Lessee shall at all times prior to return of an item to Lessor procure and continuously carry, maintain and pay for [insurance].

10. [Lessee shall pay all taxes and ensure Heller's tax deductions and credits.]

11. [Lessee shall maintain, service and repair the property.]

12. ... Unless a purchase option is exercised, Lessee shall deliver and surrender the equipment to Lessor at the end of the Term or Renewal Term. ...

13. Each lease is a net lease. Lessee assumes all risk of and shall indemnify and hold harmless Lessor from and against all damage to and loss of the Equipment from any cause whatsoever ... Upon the occurrence of an Event of Loss, at its option Lessee shall: (i) repair ... (ii) replace ... or (iii) pay

³ It is also attached as Exhibit F to the Mortensen affidavit (docket 7).

Lessor in cash the Stipulated Loss Value, as defined... ..

14. Lessee has not and by execution and performance hereof will not have or obtain any title to the Equipment or any other interest therein except as Lessee hereunder and subject to all the terms hereof. Title to the Equipment shall at all times remain in Lessor and Lessee at its expense shall protect and defend the title of Lessor and keep it free of all claims and liens... Lessee will treat this transaction as a lease for tax purposes ... Notwithstanding the express intent of the parties, should a court of competent jurisdiction determine that this Agreement is not a true lease, but rather one intended as security, then solely in that event and for the expressly limited purposes hereof, Lessee shall be deemed to have hereby granted Lessor a security interest in this Lease, the Equipment

16. (a)[At the expiration of the lease term]... Lessee will give written notice electing one of the following options ... (i) renew the lease as to all such terms at their Fair Market Rental Value (as defined below) ... (ii) purchase all such items for their Fair Market Value (as defined below) ...; or (iii) return all such items to Lessor... (b) At the expiration of the Term or Renewal Term of each item that Lessee does not purchase, Lessee will at its sole expense and risk de-install, pack, and crate such items and return them to Lessor ... (c) The "Fair Market Value" and "Fair Market Rental Value" of any item shall be the amount that would be paid for an item in an arm's length transaction between an informed and willing buyer or lessee (other than a used equipment dealer) to an informed and willing seller or lessor, neither under any compulsion or buy, sell or lease. Costs of removal from the location of use shall not be deducted from such value.

... ..
24. ... (d) This lease shall be governed by and construed according to the laws of the state of Washington, without regard to the conflicts of laws provisions thereof.

... (f) This lease cannot be cancelled or terminated except as expressly provided herein.

Attached to the Lease are various documents. "Equipment Lease No. One", describes the equipment, having a total price of \$4,680,966.91 for store numbers 953, 954, the warehouse, and "new floor cleaning equipment located at various Equipment locations."

One "Lease Closing Schedule" details the floor cleaning equipment, having a cost of \$684,396.17. The lease calls for 60 monthly payments of \$14,510.02 for a total sum of \$870,601.20. The stipulated loss values start at 103.16% for the first year, and decline to 17% in year six. This lease closing schedule grants the debtor a purchase option under which debtor can purchase all the equipment at the end of the 48th month (only) for the amount of 24.44% of the acquisition cost plus taxes.

A second "Lease Closing Schedule" details the equipment for stores 953 and 954 and the warehouse, having a cost of \$3,996,570.74. The lease calls for 60 monthly payments of \$77,213.75 for a total sum of \$4,632,825.00. The stipulated loss values start at 102.95% for the first year, and decline to 15% in year six.

2. The Heller equipment leases cover substantially all of the furniture, fixtures, and equipment in stores numbered

953 and 954, as well as the Debtor's product distribution center in El Paso, Texas.

3. Debtor voluntarily converted its chapter 11 case to a chapter 7 on December 19, 2001, and Yvette J. Gonzales was appointed interim Chapter 7 trustee.
4. The Heller leases were entered into as part of several sale-leaseback transactions, in which Debtor purchased the equipment for a store, then sold it to the lessors and leased it back. In some cases the Debtor owned the equipment at the time of the sale-leaseback; in other cases the Debtor purchased the equipment at the time of the transaction.
5. Steven L. Mortensen, President of the Debtor, submitted an affidavit in which he estimated that it would cost \$25,000 to remove the equipment from each location and that replacement equipment for each location would be \$300,000. He also claims that there would be operational losses associated with equipment returns ranging from \$147,000 to \$293,000 per store.
6. Heller submitted the affidavit of Jose F. Taveras, who has 15 years of experience in the architectural design of grocery stores, and who has replaced shelving and other equipment more than 100 times and has closed over 150

stores. He believed the remaining economic life for the Heller furniture, fixtures, and equipment was 72 months. He also believed that the fair market value of the equipment at the end of Heller's leases would be more than \$700,000, based on the loss values stipulated to by the Debtor in the Heller leases. Further, he stated that the cost of replacing shelving and other equipment located at stores 953 and 954 and the distribution center (not including the cost of new shelving and other equipment) would be substantially less than \$325,000 per location. He also stated that in 99% of cases, grocers do not close stores to replace shelves, and that items could be replaced without disrupting or ceasing operations.

7. Heller also submitted the affidavit of William Tefft, Senior Vice President of Asset Management for Heller Financial Leasing, Inc. (Docket 27). He stated that if conduit and or refrigeration piping is leased with other equipment they are not returned at the end of the lease with the other equipment. He stated that a lessee may chose to spend the equivalent of one or more month's lease payments to return equipment that is no longer needed rather than to purchase it. He also noted that

closing a store at the end of a lease may be a sensible alternative at the end of an equipment lease. Finally, he states that in the vast majority of cases the installation of new conduit, piping, or operating equipment would not require closing the store.

DISCUSSION

The determination of whether the Heller lease is a true lease or disguised secured transaction is governed by state law. See e.g., In re Edison Brothers Stores, Inc., 207 B.R. 801, 807 (Bankr. D. De. 1997).

The Court must first analyze the lease in light of UCC 1-201(37) to determine if the documents create a security interest or a lease agreement. Under UCC 1-201(37) the intent of the parties is not the primary consideration. Taylor, 209 B.R. at 484. Rather, a lease is construed as a security interest as a matter of law if the debtor cannot terminate the lease and one of the enumerated four requirements of UCC 1-201(37) is satisfied. Id. See also PsiNet, Inc. v. Cisco Systems Capital Corporation (In re PsiNet, Inc.), ___ B.R. ___, 2001 WL 1657612 (Bankr. S.D. N.Y. 2001)(UCC 1-201(37) contains an objective test that sets out a bright line test.) Then, if the court determines that the transaction is not a disguised security agreement per se, it must look at the facts

of the case to determine whether the economic reality of the transaction suggests a true lease or a secured transaction. Id. See In re Triplex Marine Maintenance, Inc., 258 B.R. at 669 ("If a court determines that the consideration of this exception [whether a finding of a security interest is compelled under §1.201(37)(B)] does not compel a conclusion that a security interest was created per se, it should proceed to a [sic] examination of all of the facts to determine whether the economic realities of a particular transaction create a security interest.").

Washington Statute § 62.A.1-201(37)(hereafter "UCC 1-201") provides a codified distinction between documents creating security interests and lease agreements. It provides, in part:

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 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;
- (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; or
- (f) The amount of rental payments may or will be increased or decreased by reference to the amount realized by the lessor upon sale or disposition of the goods.

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 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.

Washington Statute § 62.A.1-201(37) is substantially identical to New Mexico's version of the statute, § 55-1-201(37) NMSA 1978 (1993 Repl.).

The Heller lease is noncancellable by the debtor. See Heller Lease, ¶ 2 and ¶ 24(f). Therefore, the Court must next determine if any of the four "residual value factors" of UCC 1-203(37) are satisfied. See E. Carolyn Hochstadter Dicker and John P. Campo, *FF&E and the True Lease Question: Article 2A and Accompanying Amendments to UCC Section 1-201(37)*, 7 Am. Bankr. Inst. L. Rev. 517, 537 (1999) (The second part of UCC 1-201(37)'s test examines whether lessor is not retaining a substantial residual interest in the leased property.)

- a. Is the original term of the lease equal to or greater than the remaining life of the goods?

Equipment Lease No. 1 has a 60 month term. The stipulated loss values decrease from 102.95% in year one to 15% in year six in increments of approximately 15% annually. The lease closing schedule states that the loss value for years seven through ten are "NA". It therefore appears that after 6 years the stipulated loss value would be zero, indicating to the Court that the parties expected the equipment would not have value after year 6. Stipulated loss value does not, however, per se determine whether a piece of equipment is at the end of its useful life.

On the other hand, the Taveras affidavit stated that the remaining economic life for the Heller furniture, fixtures, and equipment was 72 months. And, the Mortensen deposition, pp. 10-11 indicates that there is a market for used equipment.

Summary judgment is not appropriate because there is a genuine issue of fact related to the economic life of the goods.

- b. Is the lessee bound to renew the lease for the remaining economic life of the goods or bound to become the owner of the goods?

No. Heller Lease ¶ 16 states the options available to Debtor at the end of the lease. Debtor could renew the lease at fair market rental value, purchase all items at their fair

market value, or return the items. In Mortensen's deposition, p. 13, he also stated that return of equipment would be one of several possible rational decisions one could make at the end of a lease.

c. Does the lessee have 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?

Heller lease ¶ 16(a)(i) gives Debtor the right to renew the lease at the fair market rental.

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.

UCC 1-201(37)(a). However, if the fair market rent is itself nominal (because, for example, of no market for the goods, or the goods are outdated, in poor shape, or are otherwise at the end of their economic lives) the Court will find the lease to be a secured transaction. Hochstadter and Campo, 7 Am. Bankr. Inst. L. Rev. at 541-42.

In this case, there is nothing in the record to indicate the actual fair rental value of the goods, or the fair rental value of the goods as projected at the time the lease was executed. Summary judgment is therefore not appropriate.

Also, as discussed above, there is a genuine issue regarding the economic life of the goods.

- d. Does the lessee have an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement?

Debtor has the option to purchase the goods at their fair market value. See Heller Lease ¶ 16(a)(ii).

Additional consideration is not nominal if ...(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

UCC 1-207(37)(a). However, if the fair market value is itself nominal (because, for example, the goods are outdated, in poor shape, or otherwise at the end of their economic lives) the Court will find the lease to be a secured transaction. In re Edison Brothers Stores, Inc., 207 B.R. 801, 810 (Bankr. D. De. 1997):

[E]ven if the lease agreement provides that the lessee has an option to purchase the leased property for its fair market value at the end of the lease term (as is the case before me), it may still indicate that a security arrangement was intended if the remaining value of the property at the end of the lease term can be shown to be negligible or insignificant.

The record contains disputed facts regarding the present fair market value of the goods. For example, the Taveras affidavit states that the value is \$700,000, although this

value is based on loss values that appear in the lease, not on any appraisal. Debtor disputes this value as being based on the lease document itself, not on an appraisal of actual fair market value.

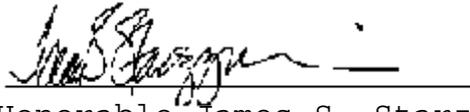
Debtor also deducts from its version of the fair market value the cost of removal and the economic costs associated with closing stores to facilitate removal of the equipment. Debtor argues that these costs amount to economic compulsion that it exercise the option. The leases, however, specifically do not allow consideration of removal costs. Without deciding whether the lease provision is binding in this situation, the Court finds that there is also a dispute what these removal costs would be. Compare Mortensen affidavit ¶ 8 (Costs of removal exceed \$539,000 per store), with Taveras affidavit ¶ 5 (Costs of removal would be substantially less than \$325,000 per location.)

Does the economic reality of the Heller transaction suggest a true lease or a secured transaction?

In these motions for summary judgment the Court finds that there are genuine issues of material fact relating to the lives of the leased goods and their values such that judgment cannot be granted on the basis of the "economic realities" test.

ORDER

Debtor's Motion for Summary Judgment and Heller's Motion
for Summary Judgment are both denied.



Honorable James S. Starzynski
United States Bankruptcy Judge

I hereby certify that on February 1, 2002, a true and correct
copy of the foregoing was either electronically transmitted,
faxed, delivered, or mailed to the listed counsel and parties.

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