

1 Lease vs. Security Interest  
2 Eligibility under Chapter 12  
Chapter 12 Confirmation Issues

3 In re Mary Loftis

600-60318-fra12

4 5/5/00

Alley

Unpublished

5 The Debtor is a 68 year old woman with a farm in Marion County  
6 whose husband died in 1999. During 1999, the Debtor and her husband  
7 had joint gross income from farming operations of \$41,767, the  
8 Debtor had separate gross income of \$23,597, and the Debtor's late  
9 husband had separate income of \$25,931. The Debtor filed bankruptcy  
10 in January of 2000, filing a proposed plan of reorganization under  
11 Chapter 12 which contemplated a 15 year period to pay her debts.  
One creditor objected on the grounds that the agreement denominated  
as a security interest by the Debtor was in fact a lease of farm  
equipment which must be either assumed or rejected and the default  
cured. A second creditor objected on grounds of good faith,  
feasibility, and eligibility.

12 The court held that the "lease" agreement in question was in  
13 fact a security interest under ORS 71.2010(37). The lessee had an  
14 obligation to continue paying consideration for the term of the  
15 lease and did not have the option to terminate the agreement, and  
the original term of the lease was equal to or greater than the  
remaining economic life of the equipment as determined with  
reference to the facts and circumstances present at the time the  
transaction was entered into.

16 To be eligible to file under Chapter 12, inter alia, a Debtor's  
17 gross farm income from the previous year must be greater than 50% of  
18 all gross income. The creditor argued that the farm income when  
19 compared to combined 1999 income of the Debtor and her husband did  
20 not meet the minimum required. Further, if  $\frac{1}{2}$  the farm income were  
21 compared to the Debtor's separate income, it still constituted less  
than 50% of the total. The court held that the 1999 farm income was  
earned jointly by the Debtor and her late husband and should not be  
divided for purposes of the eligibility test. When compared to the  
Debtor's separate income from 1999, the requirement for eligibility  
was met.

22 The court rejected the creditor's good faith objection - there  
23 was no indication that the Debtor was in ill health or would  
24 otherwise be unable to complete plan payments. Moreover, the Code  
25 allows a plan to continue after the death or incapacity of a Debtor  
26 if in the best interest of the parties. A determination the court  
said should be made when and if the time arose, not in the context  
of confirmation. The court, however, sustained the creditor's  
objection on feasibility grounds, finding that the Debtor had failed  
to account for income and self-employment taxes in her calculation  
of projected income available for plan payments.

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UNITED STATES BANKRUPTCY COURT  
FOR THE DISTRICT OF OREGON

In Re: ) Bankruptcy Case No.  
 ) 600-60318-fra12  
MARY JOYCE LOFTIS, )  
 ) MEMORANDUM OPINION  
Debtor. )

The Debtor has proposed a plan of reorganization under Chapter 12 of the Bankruptcy Code which provides for annual payments of \$75,000.00. These payments, together with a balloon payment at the end of 15 years, will pay all secured claims at the end of the 15 year term of the plan.

One creditor, Les Bois Leasing, objects on the grounds that it believes its interest is that of a lessor, and that the Debtor must assume the lease and cure the default within a reasonable period of time. The Debtor asserts that the lease is in fact a security interest subject to modification by the plan.

A second creditor, Community First Bank, objects on three grounds: that the Debtor is ineligible for relief under Chapter 12, that the plan is not feasible, and that the plan is not proposed in good faith.



1 1985. Before the tractor and loader were acquired by the Debtor and  
2 Mr. Loftis it was in the hands of a local farmer. Arrangements were  
3 made through an area dealer to acquire the equipment, and to finance  
4 the acquisition through Les Bois Leasing, Inc.

5 On May 27, 1997, the Debtor and Mr. Loftis entered into a  
6 written agreement, denominated "Lease Agreement" with Les Bois  
7 Leasing. Schedule A to the agreement identified the equipment and  
8 assigned a total cost of \$27,000.00. The payment schedule required  
9 \$2,700.00 at the commencement of the agreement, and net annual  
10 payments of \$7,590.15 due thereafter through November 27, 2001. The  
11 lease agreement provides, among other things, that:

- 12 • The lessor made no warranties regarding the fitness or use of  
13 the equipment.
- 14 • The Debtor was solely responsible for repair, maintenance,  
15 installation of equipment, taxes, liens, and insurance on the  
16 equipment.
- 17 • Upon expiration of the term of the lease the lessee, at  
18 lessee's expense, was to return the equipment to the lessor.
- 19 • That the equipment was to remain at all times the property of  
20 Les Bois Leasing and that the Loftises would have no right,  
21 title or interest in the property except the right to use the  
22 property under the terms of the lease.
- 23 • That the Loftises would sign a financing statement "for the  
24 sole purpose of providing notice to third parties that the  
25 title to the equipment is vested in lessor."
- 26 • Finally, the parties executed an addendum providing that  
"lessor will offer to sell to lessee the equipment described  
in the above-referenced lease for a purchase price of  
\$2,700.00 plus any applicable taxes and other sums due under  
the lease."

25 The Debtor maintains that she and Mr. Loftis intended all  
26 along to purchase the equipment, and that the "lease agreement" is

1 in fact a security agreement. She testified that she depreciated  
2 the equipment on her tax returns.<sup>1</sup> One of her sons, an experienced  
3 farmer in the area, testified that he believed the equipment to  
4 still worth the \$27,000.00 or \$28,000.00 attributed to it when it  
5 was acquired.

6 A representative of Les Bois Leasing testified that he  
7 believed the useful life of the tractor and loader was 25 years,  
8 more or less. By his calculation his equipment would be worth  
9 nothing, or close to it, by the time the lease ran out in 2001. He  
10 further testified that the \$2,500.00 fee to be paid in order to  
11 acquire the equipment was based on an industry standard providing  
12 that fees of this sort be 10% of the original value.

## 13 II. ISSUES

14 The Debtor seeks confirmation of her plan. The creditors  
15 oppose confirmation, and Les Bois Leasing seeks an order requiring  
16 that its lease be assumed or rejected in the event reorganization is  
17 permitted. These contentions raise several issues for the Court to  
18 determine:

19 1. Is the Debtor eligible for relief under Chapter 12 of the  
20 Code, or was the farm income attributable to her too small in  
21 relation to her other income?

22 2. Has the Debtor carried her burden of proving that the  
23 plan is feasible?

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25 <sup>1</sup> The 1998 returns placed into evidence show both depreciation  
26 and rental expenses, but there is no way to tell whether a given  
entry applies to this particular equipment.



1 under Chapter 12 of the Code since less than 50% of the combined  
2 gross income is attributable to farm operations. However, Mrs.  
3 Loftis did not file bankruptcy with her late husband, she filed  
4 alone. The farm income attributable to the period in 1999 prior to  
5 Mr. Loftis' death was joint farm income to which the Debtor  
6 succeeded at her husband's death. The question of when the actual  
7 crop payments were received during the year is thus not relevant -  
8 the entire farm income for the year should be attributed to the  
9 Debtor. Recalculating for separate income shows that gross farm  
10 income attributed to the Debtor of \$41,767 is greater than 50% of  
11 the total gross income attributable to her of \$65,364. She  
12 therefore qualifies for relief under Chapter 12 of the Bankruptcy  
13 Code.

14 Feasibility

15 Community First Bank objects to confirmation on the ground  
16 that the proposed plan is not feasible. It argued that the Debtor  
17 has not taken into account income taxes and certain historical  
18 costs. The Debtor countered that income taxes will be eliminated by  
19 deductions for depreciation and plan payments and that many of the  
20 historical costs referred to by the creditor were a one-time  
21 expenditure which will not recur. She testified that all farm and  
22 insurance business costs have been taken into account in her  
23 projections.

24 The Chapter 12 Trustee has stated he believes the proposed  
25 plan is feasible and I have no problem with the projected business  
26 costs associated with the farm and business. I do not find,

1 however, that the Debtor has met her burden with respect to  
2 projected income and self-employment taxes.

3 Plan payments are not deductible for tax purposes unless they  
4 otherwise qualify as a current business expense. Taking the  
5 Debtor's projected figures for farm and business income and reducing  
6 the total by depreciation of \$30,000 and interest expense of \$28,529  
7 (the amount deducted in 1998) leaves taxable farm and business  
8 income of \$45,752 and a self-employment tax of approximately \$6,500.  
9 Assuming none of the Debtor's pension income is taxable and allowing  
10 deductions for one-half the self-employment tax, \$27,321 in interest  
11 (the itemized interest claimed in 1998), and a personal exemption of  
12 \$2,750, leaves federal taxable income of \$12,478 and a tax of  
13 \$1,871. Oregon income tax is likewise calculated to be \$903.  
14 Projected taxes total approximately \$9,000.

15 By my calculation and making the assumptions I have made,  
16 projected self-employment and income taxes reduce the amount  
17 available for plan payments by approximately \$9,000 per year. The  
18 Debtor has not met her burden with respect to proving the  
19 feasibility of her proposed plan.

20 Good Faith

21 Community First Bank argues that the Plan was not proposed in  
22 good faith because it proposes to pay off short term loans over the  
23 15 year term of the Plan and because the Debtor is 68 years old and  
24 a 15 year plan would put her in her 80's before all payments can be  
25 completed. There is no evidence that the Debtor is in ill health or  
26 would be unlikely to live for another 15 years. Further,

1 Fed.R.Bankr.P. 1016 permits a Chapter 12 case to proceed after the  
2 death of a debtor if further administration is possible and in the  
3 best interest of the parties. There is no reason to believe that  
4 would not be the case here; however, that decision should be made if  
5 and when the need arises, not in the context of confirmation. In the  
6 present case, the Debtor's age is not grounds to find lack of good  
7 faith. I am also not prepared to find lack of good faith on the  
8 grounds that the creditor's secured debt is being restructured over  
9 the term of the plan.

10 Lease v. Security Interest

11 Whether an agreement constitutes a true lease or a security  
12 agreement is governed by state law. In re Lisa Fay Allen, 174 B.R.  
13 293 (Bankr. D.Or. 1994) [citations omitted]. Pertinent state law  
14 regarding the agreement entered into between the Debtor and Les Bois  
15 Leasing, Inc. on May 27, 1997 is ORS 71.2010(37). That provision  
16 provides a three-part test to determine whether a lease or a  
17 security interest exists. "A transaction creates a security  
18 interest if: (1) the lessee has an obligation to continue paying  
19 consideration for the term of the lease; (2) the lessee cannot  
20 terminate the obligation; and (3) one of the four conditions  
21 described by ORS 71.2010(37) (a) (A)-(D) is met." Id. at 295.

22 Parts one and two of the three-part test are met because the  
23 Debtor is obligated to continue paying consideration for the five-  
24 year term of the agreement and does not have the option to terminate  
25 the obligation during that period. If one of the four conditions  
26 described at ORS 71.2010(37) (a) (A)-(D) is met, the agreement will

1 therefore be considered a security interest rather than a true  
2 lease. Condition (A) of that subsection reads: "The original term  
3 of the lease is equal to or greater than the remaining economic life  
4 of the goods." ORS 71.2010(37)(a)(A). "[R]emaining economic life  
5 of the goods' [is] to be determined with reference to the facts and  
6 circumstances at the time the transaction is entered into." ORS  
7 71.2010(c)(C). As stated earlier in this memorandum, a  
8 representative of Les Bois Leasing testified that at the time the  
9 agreement was entered into, it was contemplated that the useful  
10 economic life of the tractor and loader would end at the termination  
11 of the agreement in 2001. Condition (A) is therefore satisfied. A  
12 security interest was created by the agreement entered into between  
13 the Debtor and Les Bois Leasing.

#### 14 SUMMARY

15 I find that the Debtor is eligible for relief under Chapter  
16 12 of the Bankruptcy Code and that her proposed plan was filed in  
17 good faith. The agreement between the Debtor and Les Bois Leasing,  
18 Inc. to finance certain farm equipment constitutes a security  
19 interest subject to modification rather than a lease. Les Bois  
20 Leasing, Inc.'s motion to require assumption or rejection of the  
21 unexpired lease and its objection to the proposed plan is therefore  
22 denied. I also find that the Debtor has not met her burden to prove  
23 the feasibility of the proposed plan and Community First Bank's  
24 objection to confirmation is sustained to that extent.

25 Confirmation of Debtor's proposed plan of reorganization is  
26 denied for the reasons given above. Debtor's counsel may submit an

1 amended plan of reorganization within 14 days. An order consistent  
2 with this memorandum opinion will be entered.

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FRANK R. ALLEY, III  
Bankruptcy Judge