

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Unpublished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.
12 One creditor objected on the grounds that the agreement denominated
13 as a security interest by the Debtor was in fact a lease of farm
14 equipment which must be either assumed or rejected and the default
15 cured. A second creditor objected on grounds of good faith,
16 feasibility, and eligibility.

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

25 To be eligible to file under Chapter 12, inter alia, a Debtor's
26 gross farm income from the previous year must be greater than 50% of
all gross income. The creditor argued that the farm income when
compared to combined 1999 income of the Debtor and her husband did
not meet the minimum required. Further, if $\frac{1}{2}$ the farm income were
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.

27 The court rejected the creditor's good faith objection - there
28 was no indication that the Debtor was in ill health or would
29 otherwise be unable to complete plan payments. Moreover, the Code
30 allows a plan to continue after the death or incapacity of a Debtor
31 if in the best interest of the parties. A determination the court
32 said should be made when and if the time arose, not in the context
33 of confirmation. The court, however, sustained the creditor's
34 objection on feasibility grounds, finding that the Debtor had failed
35 to account for income and self-employment taxes in her calculation
36 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 Because I find that the Debtor has not met her burden with
2 respect to feasibility of the proposed plan, confirmation of the
3 plan must be denied, with leave to submit a modified plan.

4 I. FACTS

5 The Debtor is a 68 year old widow. During the calendar year
6 1999 the Debtor and her late husband received income of \$91,295.00.
7 \$41,767.00 of this amount came from farm operations, and the balance
8 from commissions and renewal commissions earned by their insurance
9 agency, and pension and social security benefits. Mr. Loftis passed
10 away in May.

11 The Debtor testified that the 1999 farm income was severely
12 depressed due to Mr. Loftis' final illness, and the fact that much
13 of the farming operation had to be turned over to third parties.
14 She has arranged to hire her sons to work on the farm in the future
15 years, and projects net revenues sufficient to pay the \$75,000.00
16 annual plan payment. 1998 tax returns show a small (\$1,043.00) loss
17 for farming operations, which obviously suggests to the contrary.
18 However, the Debtor argues that expenses and depreciation shown on
19 the 1998 Schedule F are not applicable, or will be included in the
20 plan payment, and that her projections, filed with her plan, offer a
21 more realistic view of her prospects.

22 An additional point of contention is the Debtor's interest in
23 a 1997 John Deere Model 4430 tractor, and a Model 265 loader. The
24 tractor was manufactured in 1977 but had a new factory standard size
25 engine installed before the tractor was acquired by the Debtor in
26 May 1997. The loader was manufactured sometime between 1977 and

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.¹ 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?

24 _____
25 ¹ 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 3. Was the plan submitted in good faith?

2 4. Is the interest of Les Bois Leasing a security interest
3 subject to modification, or a lease which must be assumed and cured?

4 III. DISCUSSION

5 Eligibility Under Chapter 12

6 Bankruptcy Code § 109(f) states that "[o]nly a family farmer
7 with regular annual income may be a debtor in a case pending under
8 Chapter 12" of the Bankruptcy Code. "Family farmer" is defined as
9 an

10 individual or individual and spouse engaged in a
11 farming operation whose aggregate debts do not exceed
12 \$1,500,000 and not less than 80 percent of whose
13 aggregate noncontingent, liquidated debts (excluding a
14 debt for the principal residence of such individual or
15 such individual and spouse unless such debt arises out
16 of a farming operation), on the date the case
17 is filed, arise out of a farming operation owned or
18 operated by such individual or such individual and
19 spouse, and such individual or such individual and
20 spouse receive from such farming operation more than
21 50 percent of such individual's or such individual and
22 spouse's gross income for the taxable year
23 preceding the taxable year in which the case
24 concerning such individual or such individual and
25 spouse was filed

18 11 U.S.C. § 101(18).

19 Mrs. Loftis testified that she and her late husband received
20 gross income of \$91,295 for the taxable year preceeding the year of
21 bankruptcy, with \$41,767 attributable to farm operations. Of the
22 \$49,528 in non-farm income received in 1999, \$23,597 was the
23 Debtor's separate income with the remainder attributable to Mr.
24 Loftis. If the Debtor and her husband had filed bankruptcy together
25 in the year 2000, it is clear that they would not have qualified
26

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