UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF NEW YORK

In re:

CASE NO. 02-20956

MR. TOW, INC.,

Debtor. **DECISION & ORDER**

BACKGROUND

On March 18, 2002, the Debtor, Mr. Tow, Inc. ("Mr. Tow"), filed a petition initiating a Chapter 11 case. On April 23, 2001, Mr. Tow filed the Schedules and Statements required to be filed by Section 521 and Rule 1007, which indicated that: (1) George & Swede Sales and Service, Inc. ("George & Swede") was an unsecured creditor with a claim of $204,300.00 by reason of a lease or sale of three Hyundai loaders; (2) Mr. Tow had a lease for $6,900.00 per month for the three Hyundai loaders, with a maximum term of four months, then a financing arrangement for the remaining balance of $197,400.00; and (3) BSB Bank & Trust Company ("BSB") had a blanket security interest in all of Mr. Tow's equipment.

On July 3, 2002, George & Swede filed a Motion to Modify the Stay (the "Stay Motion"), which asserted that: (1) on or about December 29, 2001, Mr. Tow and George & Swede entered into three separate Rental Agreements (the "Rental Agreements") and related Customer Orders (the "Customer Orders"), one for each of the

three Hyundai loaders; (2) each Rental Agreement provided for a monthly rental of $2,300.00 and indicated that the respective loader was to be used for snow use only; (3) the purpose of the Customer Order for each loader was to provide Mr. Tow with the purchase price of the loader in the event that it was interested in purchasing it; (4) each Customer Order also expanded the terms of the respective Rental Agreement;[1] (5) the Customer Orders were not sales contracts but were simply price quotes; (6) Mr. Tow was in default under the Rental Agreements because it failed to make payments for May, June and July 2002, and George & Swede was entitled to repossess the loaders; and (7) during the summer construction months George & Swede could rent each of the loaders for $3,600.00 per month.

On July 31, 2002, Mr. Tow interposed a Response to the Stay Motion (the "Response"), which also requested that the Debtor's Stay Motion be converted into an Adversary Proceeding under Rule 7001. The Response asserted that: (1) Mr. Tow had a multi-year

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[1] Each Customer Order stated, in part, that:

> Rental will be $2,300 per month - four months maximum 100% of paid rent will be applied towards purchase After four months, 85% of paid rent will apply to purchase. Each payment is due in advance - snow use only. 1.5% service charge on late payments - If payment is not made, loader will be picked up - must have insurance. Warranty - 6 months on 750 hours when it leaves George & Swede.

snow plowing contract with the City of Rochester, beginning with the 2001-2002 season (the "City Plowing Contract"), which required it to have at least forty pieces of various snow plowing equipment available, including a number of loaders with four-in-one buckets; (2) in order to perform under the City Plowing Contract, Mr. Tow needed to purchase additional loaders with four-in-one buckets; (3) in November 2001, Mr. Tow's principal, Robert J. Sarfaty ("Sarfaty"), began negotiating with George & Swede for the purchase of 2002 loaders with four-in-one buckets, however, George & Swede's best price for such a loader exceeded $99,000.00, which was more than Sarfaty wished to pay; (4) Sarfaty rejected a proposal that he buy three adaptable four-in-one buckets from George & Swede at a cost of $24,111.00, and then rent three used loaders for four months at $2,300.00 per loader per month, because he believed it made more economic sense for Mr. Tow to own the loaders if it was going to pay: (a) in excess of $24,000.00 for buckets that it could not use with the other loaders that it owned; and (b) more than $27,000.00 in rental payments over four months; (5) Sarfaty was also negotiating with George & Swede for the purchase of a power screen and with Monroe Tractor for the purchase of other equipment; (6) Monroe Tractor agreed to purchase three four-in-

one buckets and the power screen from George & Swede and resell them to Mr. Tow, subject to Mr. Tow securing financing from Case Credit; (7) after securing the financing for the four-in-one buckets, Sarfaty indicated to George & Swede that he wished to purchase the three used Hyundai loaders at a total cost of $225,000.00, $75,000.00 per loader; (8) George & Swede indicated that it could not finance Mr. Tow's purchase of the loaders; (9) at that time Mr. Tow could not purchase the loaders outright and it had not secured alternative financing; (10) George & Swede suggested a four to six month rental/purchase arrangement so that Mr. Tow could secure alternative financing, and it agreed that a portion of the rental payment could be applied as a credit against the purchase price, which would create an attractive equity interest for Mr. Tow when it negotiated with prospective financers; (11) Sarfaty, once again, insisted that although both parties would continue to look for financing, the written agreements must result in Mr. Tow ultimately owning the loaders; (12) Sarfaty understood that the Rental Agreements and Customer Orders entered into between Mr. Tow and George & Swede allowed Mr. Tow to acquire full ownership of the loaders after it made the necessary number of monthly payments and credits of one hundred percent and eighty-five percent were applied against

the purchase price, or earlier, if Mr. Tow could secure alternative financing; (13) although Sarfaty understood that Mr. Tow was to receive three 2001 loaders, it only received two 2001 loaders and a 2000 loader;[2] (14) when Sarfaty demanded an allowance against the purchase price for the 2000 loader, George & Swede refused to grant Mr. Tow a requested allowance of $5,000.00, what Sarfaty believed was the difference in the value between a 2000 loader and a 2001 loader; (15) if the Court agreed with Mr. Tow that these were financing arrangements rather than true leases, the $20,700.00 in rental payments made to George & Swede within ninety days of the filing of Mr. Tow's petition were avoidable preferential payments under Section 547, because George & Swede was an unsecured creditor, having failed to file the necessary UCC-1 financing statements to perfect any interest it might have retained in the loaders; and (16) the $6,900.00 paid by Mr. Tow subsequent to the filing of the petition was an avoidable post-petition unauthorized transfer under Section 549.

On August 13, 2002, George & Swede interposed the Affidavit of Michael Doyle ("Doyle"), the president of George & Swede, in

[2] The Customer Orders signed by Sarfaty covered two 2001 loaders and one 2000 loader.

support of its Stay Motion (the "Doyle Affidavit"). The Doyle Affidavit asserted that: (1) the three Hyundai loaders covered by the Rental Agreements and Customer Orders were at all times owned by George & Swede, which was clearly set forth as the owner on the respective Certificates of Origin for the loaders; (2) the Bank of Castile and Deustche Financial Services Corporation ("Deustche") each had perfected security interests in various assets of George & Swede, including one or more of the loaders covered by the Rental Agreements and Customer Orders; (3) the Customer Orders were never intended by George & Swede to be sales contracts, they were nothing more than price quotes that provided Mr. Tow with the necessary information it would need if it chose to purchase the loaders or secure financing in connection with a purchase; (4) Sarfaty confirmed in the Response that George & Swede indicated to him that it could not and would not finance Mr. Tow's purchase of the loaders; (5) Mr. Tow's payment of the rental charges for January, February and March, as well as a post-petition April payment, which would not have been required if George & Swede was merely an unperfected secured creditor, clearly evidenced Mr. Tow's understanding that the payments required under the Rental Agreements and Customer Orders were rental payments; (6)

George & Swede never gave Mr. Tow the forms necessary to transfer title to the loaders, but only gave it MV-82 Forms that enabled Mr. Tow to register the loaders, as required by the City Plowing Contract; (7) the MV-82 Forms showed Mr. Tow as the Lessee of the loaders, and a Department of Motor Vehicles search attached to the Doyle Affidavit indicated that Mr. Tow was the Lessee, not the owner of the loaders; (8) nothing in the Rental Agreements or Customer Orders specifically provided for a sale of the loaders to Mr. Tow, and even though the Customer Orders could be read to allow Mr. Tow an eighty-five percent credit against the purchase price for any monthly payment after the initial four months, this alone should not be interpreted by the Court as making the transactions financing arrangements; (9) Mr. Tow failed to make the required monthly payments, and the Rental Agreements and Customer Orders gave George & Swede the right to repossess the loaders; (10) Doyle had always indicated to Sarfaty that the agreements would cover one 2000 loader and two 2001 loaders; and (11) the actual price for a 2001 loader should have been $82,000.00, but George & Swede was prepared to stand behind the $75,000.00 quote set forth in each of the Customer Orders for the 2001 loaders.

On August 13, 2002, Mr. Tow interposed a further reply (the "Reply"), which asserted that: (1) the Court must come to the conclusion that the transactions between Mr. Tow and George & Swede were financing arrangements, rather than true leases, if it applied the analysis and factors set forth in *In re Owen*, 221 B.R. 56 (Bankr. N.D.N.Y. 1998) ("*Owen*"), as discussed and adopted by the Court in *In re TMP National Cartage Corporation,* Ch. 7 Case No. 01-22939 (W.D.N.Y. December 7, 2001) ("*TMP*"), including that: (a) if Mr. Tow continued to make the required monthly payments of $2,300.00 under the agreements, and the credits set forth in the Customer Orders were applied, it would be the owner of the loaders with no additional payments; and (b) the present value of those payments equaled or exceeded the cost of the loaders; (2) the Rental Agreements and Customer Orders must be read and interpreted together as one contract between the parties; (3) when the Rental Agreements and Customer Orders are read and interpreted together, they are consistent with Sarfaty's understanding that they afforded him the ability to be the owner of the loaders by either: (a) securing take-out financing from a third-party source to pay the balances due after any credits for any monthly payment paid; or (b) continuing to make the monthly payments until the agreed upon

credits resulted in the full payment of the purchase price for each loader; (4) the purchase by Mr. Tow of the loaders was not subject to the security interests of George & Swede's lenders because George & Swede was in the business of selling such loaders, and Mr. Tow was in the business of buying such loaders, so that the interests of the lenders were cut off by UCC Section 9-320(a);[3] (5) Mr. Tow made the April payments to George & Swede and advised George & Swede that they were authorized by the Court, because Sarfaty misunderstood the difference between the use of cash collateral in which BSB had an interest and an authorization by the Court to make a payment to an unperfected lender/financer; and (6) the pre-petition payments made by Mr. Tow to George & Swede during the preference period were not made in the ordinary course of the business of either Mr. Tow or George & Swede.

On October 10, 2002, the Court conducted an Evidentiary Hearing at which it heard the testimony of Sarfaty, Doyle and

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[3] UCC Section 9-320 Buyer of Goods

(a) Buyer in ordinary course of business. Except as otherwise provided in subsection (e), a buyer in ordinary course of business, other than a person buying farm products from a person engaged in farming operations, takes free of a security interest created by the buyer's seller, even if the security interest is perfected and the buyer knows of its existence.

CLS Uniform Commercial Code § 9-320 (2002).

Greg Newell ("Newell"), the salesman at George & Swede who prepared the Rental Agreements and Customer Orders.

On October 21, 2002, Mr. Tow filed a post-hearing memorandum (the "Mr. Tow Memorandum") which asserted that: (1) Sarfaty, on behalf of Mr. Tow, always intended to purchase the loaders covered by the Rental Agreements and Customer Orders, and always made that intention clear to Doyle and Newell when negotiating the transactions; (2) Mr. Tow's purchase of the four-in-one buckets, otherwise incompatible with its existing loaders, supported Sarfaty's intention that Mr. Tow ultimately own the loaders covered by the Rental Agreements and Customer Orders; (3) the Customer Orders were more than mere price quotes that expanded the rental terms, because, among other things, they were signed by principals on behalf of both entities, which would not have been necessary if they were mere price quotes; (4) the Customer Orders, when read together with the respective Rental Agreements, provided Mr. Tow with the ability to purchase each loader on an installment basis by payments of $2,300.00 per month for approximately thirty-seven and one-half months, once the respective credits of one hundred percent for the first four payments and eighty-five percent for each payment thereafter were applied to the purchase price; (5) Mr. Tow's assertion that

the transactions were financing arrangements was consistent with the six-month or seven hundred fifty-hour warranty provided by George & Swede beginning from the time of delivery of the loaders in December 2001, which would have been unnecessary and inapplicable if the transactions were mere lease agreements; (6) the existence of the warranty and the failure to provide any termination date for monthly payments on the Customer Order, indicate that it was the intention of the parties, and the economic reality of the transactions, that the transactions were contracts to purchase the loaders; (7) the Rental Agreements provided for UCC filings, which Doyle at the Evidentiary Hearing testified were inadvertently not made; (8) Doyle also testified at the Evidentiary Hearing that the Rental Agreements did not include a stamped legend, required by Deustche, that would have made it clear that one or more of the loaders were subject to a security interest in favor of Deustche; (9) the fact that Mr. Tow's registration of the loaders indicated that it was a lessee was not dispositive; (10) the intention of Sarfaty was consistent with his policy of never renting heavy equipment, but always purchasing it outright or through financing; and (11) the present value of the payments that were to be credited against the purchase prices under the Rental Agreements and Customer

Orders, if made for thirty-eight months, exceeded or were equal to the $75,000.00 purchase price of the loaders, so that George & Swede would always receive a return on its investment.

On October 31, 2002, George & Swede filed a post-hearing memorandum (the "George & Swede Memorandum"), which asserted that: (1) in his testimony at the Evidentiary Hearing, Sarfaty continually indicated that he was not the owner of the loaders but that he was leasing them from George & Swede; (2) Sarfaty's testimony at the Evidentiary Hearing was consistent with his prior admission that George & Swede had made it clear to him that it could not and would not finance his purchase of the loaders; (3) as set forth by the Bankruptcy Court in its decision in *In re Edison Brothers Stores, Inc.*, 207 B.R. 801 (Bankr. D.Del. 1997) ("*Edison*"), in determining under UCC Section 1-201(37)[4] whether a transaction is a true lease or

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[4] UCC Section 1-201(37) provides in part that:

"Security interest" means 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, 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 the owner of the goods,

disguised financing arrangement, the Court must look to the facts of each case, examine the intent of the parties, and look to the economic reality of the transaction; (3) at all times George & Swede intended the transactions to be leases of the loaders, even though the Rental Agreements and Customer Orders, when read together, may not fully and clearly set forth that intention; (4) the mutual intention of Mr. Tow and George & Swede was that: (a) Mr. Tow would lease the loaders on a month-to-month basis; (b) George & Swede had the ability to terminate

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> (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
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> (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.
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> A transaction does not create a security interest merely because it provides that:
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> (a) a 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, or
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> (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.

NY U.C.C. § 1-201(37) (2002).

the lease if Mr. Tow failed to make the payments or otherwise abide by the terms of the Rental Agreements and Customer Orders; and (c) Mr. Tow had the right to purchase one or more of the loaders if it secured third-party financing; (5) Mr. Tow had no other option but to lease the loaders from George & Swede, since it needed them for the City Plowing Contract and it could not otherwise purchase the loaders outright and it had not secured third-party financing; and (6) Sarfaty repeatedly indicated in his testimony that he did not own the loaders, but was leasing them from George & Swede with at best an ability to purchase them under certain conditions.

DISCUSSION

I. Financing Arrangement or True Lease

Based upon all of the facts, circumstances and evidence presented, Mr. Tow has met its burden under UCC Section 1-201(37) and the decisions in *Owen*, *TMP* and *Edison*, to demonstrate that the transactions in question were a financing arrangement rather than true leases.

Although the parties may have had an expectation that before the end of April 2002, or shortly thereafter, Mr. Tow would obtain third-party take-out financing that would allow it to prepay any remaining balances due to George & Swede, after the

application to the purchase prices of the credits for a portion of the monthly payments it had made, the arrangement entered into between the parties, evidenced by the Rental Agreements and Customer Orders, was the equivalent of an installment purchase agreement. That agreement enabled Mr. Tow to purchase the three loaders covered by the Rental Agreements and Customer Orders by making payments of $6,900.00 per month until the agreed upon credits equaled the purchase prices of the loaders, a period of approximately thirty-seven and one-half months.

Clearly Mr. Tow had no economic incentive to close on any take-out financing before the expiration of the initial four months, since it was receiving a one hundred percent credit against the purchase prices for all the monthly payments it made. However, after the initial four-month period, since Mr. Tow was only then receiving an eighty-five percent credit against the purchase prices,[5] it had every incentive to obtain take-out financing, which, given the rate environment of 2002, would likely have been at an interest rate of less than seventeen percent per annum.

[5] Over the approximately thirty-three and one-half months this would be an effective interest rate of approximately seventeen percent per annum.

It may have been that the representatives of George & Swede did not intend for the Rental Agreements and Customer Orders, which must be read together as one unified agreement for each loader, to be the equivalent of installment purchase agreements. However, from the papers submitted and the testimony elicited during the Evidentiary Hearing, it is clear that Sarfaty always intended and understood that these agreements between George & Swede and Mr. Tow would ultimately result in Mr. Tow owning the loaders, whether by take-out financing, or, if such financing could not be obtained, by continuing the monthly payments and obtaining the agreed upon credits against the purchase prices.

Although there are facts and circumstances as well as specific provisions of the Rental Agreements and Customer Orders which could support either finding, that the agreements were financing arrangements or true leases, the bottom line is that the agreements afforded Mr. Tow the ability, in its sole discretion, to continue to make $6,900.00 per month payments until the agreed upon credits resulted in it being the owner of the loaders. As perhaps inartfully testified to by Sarfaty at the Evidentiary Hearing, the agreements provided Mr. Tow with a mechanism by which, one way or another, it was going to be the owner of the loaders, never a mere lessee.

It may also have been that the representatives at George & Swede did not fully appreciate the applicable law in this area or anticipate Mr. Tow's bankruptcy filing. However, by Mr. Tow invoking its jurisdiction, this Court has been required to carefully scrutinize the Rental Agreements and Customer Orders, and the less-than-precise drafting by the representatives of George & Swede, together with the evidence of Sarfaty's intentions and understandings of the agreements, has resulted in a set of agreements that can only be found to be security agreements/financing arrangements, not true leases.

The facts, circumstances and evidence presented that support the finding that the transactions in question were financing arrangements and not true leases, include: (1) Doyle's testimony that the UCC filings contemplated by the Rental Agreements were inadvertently not made; (2) the absence of a lease termination provisions in agreements; (3) the provisions for a warranty that runs from the time that the loaders were delivered to Mr. Tow, which is inconsistent with a true lease arrangement; and (4) the credibility of Sarfaty's testimony regarding his intentions and understanding that the agreements, when performed, would result in Mr. Tow being the owner of the loaders.

II. <u>Other Issues</u>

Mr. Tow has raised the additional issues of whether: (1) the payments made to George & Swede by Mr. Tow during the preference period may be found to be avoidable preferential transfers; (2) the post-petition payment made by Mr. Tow to George & Swede may be found to be after the avoidance of any security interest George & Swede may have had in the loaders, an avoidable unauthorized post-petition transfer; and (3) whether BSB has a perfected security interest in them for the purposes of the Chapter 11 proceeding and the acceptance of a plan. As a result of the findings by this Court that: (1) the arrangement between the parties was a financing arrangement, rather than a true lease arrangement; and (2) as a result, George & Swede is an unperfected secured creditor for the balance of the purchase prices due on the loaders, it may be in the best interests of Mr. Tow, George & Swede and all of the creditors of Mr. Tow, including BSB, to afford the parties an opportunity to negotiate a plan of arrangement that is acceptable to all of Mr. Tow's creditors and confirmable by the Court, before the Court is required to decide these additional issues.

CONCLUSION

The Rental Agreements and Customer Orders covering the three loaders in question are financing arrangements, rather than true

leases, and because George & Swede failed to file financing statements in connection with those agreements, it is an unperfected secured creditor for the balance of the purchase prices due on the loaders.

The Court will conduct a pretrial on the issues of avoidable preferential transfers, post-petition payments and perfected security interests in the loaders, only if Mr. Tow, in writing, notifies the Court that it wishes a pretrial in connection with these issues because it cannot otherwise negotiate a plan of arrangement that resolves the issues.

IT IS SO ORDERED.

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HON. JOHN C. NINFO, II
CHIEF U.S. BANKRUPTCY JUDGE

Dated: December 11, 2002