UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF MISSISSIPPI

IN RE:

LEON MAJOR JOHNSTON AND
FRANCES LYNN JOHNSTON, **CASE NO. 10-04143-NPO**

DEBTORS. **CHAPTER 13**

MEMORANDUM OPINION AND ORDER
SUSTAINING OBJECTION TO CONFIRMATION OF
DEBTORS' CHAPTER 13 PLAN BY GOLD CAPITAL, LLC

On February 7, 2011, there came on for hearing (the "Hearing") the Objection to Confirmation of Debtors' Chapter 13 Plan by Gold Capital, LLC (the "Objection") (Dkt. No. 19) filed by Gold Capital, LLC ("Gold Capital") and the Response to Objection to Confirmation of Debtors' Chapter 13 Plan by Gold Capital, LLC (the "Response") (Dkt. No. 22) filed by Leon Major Johnston and Frances Lynn Johnston (together, the "Johnstons"). At the Hearing, J. Thomas Ash appeared on behalf of the Johnstons, and William R. Armstrong, Jr., appeared on behalf of Gold Capital. The Court, having considered the evidence and arguments of counsel, finds that the Objection should be sustained for the reasons set forth below.

Jurisdiction

The Court has jurisdiction of the parties to and the subject matter of this proceeding pursuant to 28 U.S.C. § 1334. This matter is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(L). Notice of the Objection was proper under the circumstances.

Facts[1]

Most of the facts before the Court are those contained within the Rental Purchase Agreement and Disclosure Statement (the "Rental Contract") that is the subject matter of this contested matter.

1. On September 30, 2009, Frances Lynn Johnston ("Mrs. Johnston") entered into the Rental Contract with Graceland Rentals, LLC, pursuant to which she purportedly leased a portable storage building, described in the Rental Contract as a "10 x 12 Lofted Barn" (the "Shed"). (Ex. 1 ¶ 2(a)).

2. The Rental Contract required Mrs. Johnston to pay Gold Capital rent in the amount of $125.55 per month, including sales tax. (Ex. 1 ¶ 2(f)). The term of the Rental Contract was for one month only, but Mrs. Johnston could renew the term automatically for additional consecutive months by making advance payments. (Ex. 1 ¶¶ 2(d)-(e)). Also, she could terminate the Rental Contract without penalty by ceasing all payments and surrendering the Shed. (Ex. 1 ¶ 4).

3. The "cash price" of the Shed was listed in the Rental Contract as "$2797.00 + Sales Tax." (Ex. 1 ¶ 2(b)). If Mrs. Johnston renewed the lease for 36 months (for a total payment of $4523.04), she would obtain ownership of the Shed without any additional consideration. (Ex. 1 ¶ 2(f)). Also, at any time after the initial one-month term, Mrs. Johnston could purchase the Shed for "$2797.00 + Sales Tax less 60% of all the rental payments" previously made. (Ex. 1 ¶ 2(f)).

4. Mrs. Johnston uses the Shed to store personal belongings.

5. On October 13, 2009, Graceland Rentals, LLC assigned the Rental Contract to Gold Capital. (Ex. 1 p. 3).

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[1] Pursuant to Fed. R. Civ. P. 52, as made applicable by Fed. R. Bankr. P. 7052 and 9014, the following constitutes the findings of fact and conclusions of law of the Court.

6. On November 22, 2010, the Johnstons filed a voluntary petition for relief (the "Petition") (Dkt. No. 1) under chapter 13 of the Bankruptcy Code.

7. When the Johnstons filed their Petition, Mrs. Johnston was one month behind in her payments under the Rental Contract. (Ex. 2). As of that date, she had paid Gold Capital $1552.69, not including sales taxes or late fees. (Ex. 2).

8. The Johnstons filed a proposed chapter 13 plan ("Plan") (Dkt. No. 7) which treats Gold Capital as a secured creditor with collateral consisting of the Shed. The Plan lists the allowed secured value of the Shed as $200.00 and proposes to pay that amount to Gold Capital over 60 months, at 7% interest, in monthly installments of $3.96. See 11 U.S.C. § 1325(a)(5)(B).[2]

9. The Plan contemplates continued use and possession of the Shed by the Johnstons but makes no provision for the assumption of the Rental Contract or for curing any defaults, both of which are requirements under § 365 for any transaction involving an unexpired lease or an executory contract. See 11 U.S.C. § 1322(b)(7) (providing for assumption or rejection in a chapter 13 plan).

10. Gold Capital objects to its treatment under the Plan on the ground that the Rental Contract is a "true" lease and not a security agreement. For this reason, Gold Capital maintains that the Plan does not meet the requirements for confirmation under § 1325.

Discussion

The Objection and the Response require the Court to consider the proper treatment of the Rental Contract. Mrs. Johnston contends that the Rental Contract is a disguised security agreement

[2] Hereinafter, all code sections refer to the United States Bankruptcy Code, located at Title 11 of the United States Code, unless specifically noted otherwise.

and that she should be allowed to retain possession and use of the Shed by paying Gold Capital its value through the Plan. That value ($200.00) is considerably less than the anticipated rent due under the Rental Contract ($1,500.00), according to the Plan. Gold Capital, on the other hand, contends that the Rental Contract is a "true" lease, and that Mrs. Johnston may retain possession and use of the Shed only by complying with the assumption provisions of § 365. See 11 U.S.C. § 1322(b)(7). Otherwise, Gold Capital asserts ownership of the Shed.

A. Choice of Law

In determining whether a particular transaction is a "true" lease or a disguised security agreement, the Court must consider state law. See Butner v. United States, 440 U.S. 48 (1979) (holding that property interests in bankruptcy cases are created and defined by state law). Under these facts, the Court must decide as a preliminary matter whether the substantive law of Kentucky or Mississippi governs this issue. In making this determination, the Court must apply the choice-of-law rules of Mississippi, the forum state. Caton v. Leach Corp., 896 F.2d 939, 942 (5th Cir. 1990) (citing Day & Zimmerman, Inc. v. Challoner, 423 U.S. 3, 4 (1975)).

The Rental Contract contains a choice-of-law provision stating that the "laws of the State of Kentucky, the home state of [Graceland Rentals, LLC], shall govern this contract in all respects." (Ex. 1 ¶ 15). It appears from the record that Kentucky has no other relation to the parties in this matter[3] and never had any relation to the transaction itself. Mississippi, in comparison, has an abundance of contacts: Mississippi is where Mrs. Johnston resides, where the Rental Contract was negotiated, and where the subject matter of the Rental Contract is located. In Mississippi, parties

[3] The record suggests that Kentucky is the principle place of business of both Graceland Rentals, LLC and Gold Capital. See Ex. 2.

may choose the law of the jurisdiction that governs their transaction, provided the jurisdiction has a reasonable relation to the transaction. Miss. Code Ann. § 75-1-105(1). Here, the absence of a sufficiently appropriate relation to Kentucky renders the choice-of-law provision in the Rental Contract unenforceable. Moreover, assuming for the sake of argument that the Rental Contract is a consumer lease, Miss. Code Ann. § 75-2A-106 specifically preempts a contractual choice-of-law provision that applies the law of a jurisdiction where the consumer does not reside. See Miss. Code Ann. § 75-2A-103(c) (generally defining a consumer lease as a lease made to an individual for household goods where the payments total less than $25,000.00). Either way, Mississippi choice-of-law rules require, in the absence of a valid contractual provision, application of the law of the state with the most significant contacts to the transaction and the parties. Price v. Int'l Tel. & Telegraph Corp., 651 F. Supp. 706, 710-11 (S.D. Miss. 1986); O'Rourke v. Colonial Ins. Co., 624 So. 2d 84, 86 (Miss. 1993). In this matter, that state is clearly Mississippi. However, the outcome of this matter would be the same under the law of either Kentucky or Mississippi because both jurisdictions have enacted laws that define and treat rent-to-own contracts in the same way.[4]

B. Is the Rental Contract a "True" Lease, a Security Agreement, or Something Else?

The Rental Contract at issue here is a type of consumer contract, known as a rent-to-own contract, that has provoked fierce debate in the bankruptcy courts about how best to classify them because of their hybrid nature.[5] Is the Rental Contract a "true" lease, a security agreement, or something else? Under the Rental Contract, Mrs. Johnston pays a monthly fee in advance for use of the Shed and, significantly, may walk away from the Rental Contract without any further

[4] See infra note 8.

[5] See generally Jim Hawkins, Renting the Good Life, 49 Wm. & Mary L. Rev. 2041 (2008).

monetary obligation to Gold Capital. These provisions are characteristic of a "true" lease. On the other hand, there are provisions in the Rental Contract that are characteristic of a security agreement. For example, Mrs. Johnston may become the owner of the Shed by merely renewing the lease term for a total of 36 months. Until then, Mrs. Johnston assumes responsibility for maintaining the Shed and for any risk of loss if it is stolen or destroyed. Also, Mrs. Johnston pays a sales tax as part of each monthly rent payment.

Gold Capital argues in its Objection that this issue is determined in Mississippi by reference to the definition of a "security interest" set forth in Miss. Code Ann. § 75-1-201(37) (renumbered as Miss. Code Ann. § 75-1-203 in 2010). Gold Capital focuses upon part (b) of that definition, which lists certain criteria for determining whether a transaction in the form of a lease creates a "true" lease or a security interest. Miss. Code Ann. § 75-1-201(37)(b). Gold Capital cites numerous decisions holding that rent-to-own contracts are not security agreements under these criteria because of the absence of an obligation to pay a sum certain beyond the weekly or monthly rental fee. See Powers v. Royce Inc. (In re Powers), 983 F.2d 88 (7th Cir. 1993) (rental agreements for household goods which debtor could terminate at any time were "true" leases under U.C.C. § 1-201(37)); Morris v. U.S. Bancorp Leasing & Fin. (In re Charles), 278 B.R. 216 (Bankr. D. Kan. 2002) (agreement was a "true" lease under the revised version of U.C.C. § 1-201(37)); In re Copeland, 238 B.R. 801 (Bankr. E.D. Ark. 1999) (rent-to-own contract for portable building that included $1.00 purchase option at the end of the lease term was a "true" lease under § 1-201(37)); In re Armstrong, 84 B.R. 94 (Bankr. W.D. Tex. 1988) (rent-to-own contract that was terminable at will simply by ceasing payment was a "true" lease under UCC § 1-201(37) even though it contained an option to purchase the goods for nominal consideration); Homeway Rentals v. Martin (In re Martin), 64 B.R.

1 (Bankr. S.D. Ga. 1984) (nine-foot freezer was subject of a "true" lease because of termination right conferred on the debtor). However, these cases are inapposite because Mississippi has enacted a statute that specifically defines and regulates rent-to-own contracts, including the Rental Contract at issue here.[6]

In order to resolve thorny questions about the applicability of consumer credit and usury laws to rent-to-own contracts, Mississippi, like most other states, enacted the Rental-Purchase Agreement Act (the "Act"), Miss. Code Ann. §§ 75-24-151 to 75-24-175, for the purpose of treating such contracts as a distinct category of personal property leases.[7] The Act defines a "rental-purchase agreement" as "an agreement for the use of personal property by a natural person primarily for personal, family or household purposes, for an initial period of four (4) months or less that is automatically renewable with each payment after the initial period, but does not obligate or require the consumer to continue renting or using the property beyond the initial period, and that permits the consumer to become the owner of the property." Miss. Code Ann. § 75-24-153(f). The Rental Contract falls squarely within this statutory definition: It is a contract for the use of personal property; it was entered into by Mrs. Johnston, who is an individual; it involves the lease of property being used for household purposes; it has an initial lease period of one month; it is automatically renewable upon payment in advance of each month's rent; it allows an opportunity for Mrs. Johnston to become the owner of the property after three years but does not obligate her to renew the contract

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[6] See Susan Lorde Martin & Nancy White Huckins, Consumer Advocates vs. The Rent-to-Own Industry: Reaching a Reasonable Accommodation, 34 Am. Bus. L.J. 385 (Spring 1997). Gold Capital discussed Kentucky's version of this statute in its Objection, but did not mention Mississippi's.

[7] Id.

for any length of time beyond one month; and it grants Mrs. Johnston the right to terminate the agreement without penalty.

Significantly, the Act excludes rental-purchase agreements from the definition of a "security interest" under Miss. Code Ann. § 75-1-201:

> (1) Rental-purchase agreements as defined in Sections 75-24-151 through 75-24-175 are not governed by the laws relating to:
>
> * * *
>
> (c) A security interest as defined in Section 75-1-201 of the Uniform Commercial Code.

Miss. Code Ann. § 75-24-155(1)(c). Thus, because the Rental Contract meets all the criteria for a rental-purchase agreement and because such agreements are excluded by law from Miss. Code Ann. § 75-1-201(37), the Court rejects Mrs. Johnston's contention that it constitutes a disguised security agreement under the definition set forth in that statute.[8]

Some bankruptcy courts analyzing state legislation similar to Mississippi's have concluded that rent-to-own contracts are "true" leases. See, e.g., In re Rembert, 293 B.R. 664 (Bankr. M.D. Pa. 2003); In re Street, 214 B.R. 779 (Bankr. W.D. Pa. 1997); In re Rigg, 198 B.R. 681 (Bankr. N.D. Tex. 1996); In re Trusty, 189 B.R. 977, 981 (Bankr. N.D. Ala. 1995); In re Osborne, 170 B.R. 367 (Bankr. M.D. Tenn. 1994); In re Connelly, 168 B.R. 714 (Bankr. W.D. Wash. 1993); Rent-A-Center, Inc. v. Mahoney (In re Mahoney), 153 B.R. 174 (E.D. Mich. 1992); In re Morris, 150 B.R. 446 (Bankr. E.D. Mo. 1992); In re Harris, 102 B.R.128 (Bankr. S.D. Ohio 1989); Shamrock Rental Co. v. Huffman (In re Huffman), 63 B.R. 737 (Bankr. N.D. Ga. 1986). Other bankruptcy courts engaging in the same analysis, however, have concluded that rent-to-own contracts are peculiar hybrid transactions that are neither "true" leases nor security agreements but are sufficiently executory in

[8] In 1990, Kentucky enacted a Rental-Purchase Agreement statute that contains similar provisions. See Ky. Rev. Stat. Ann. §§ 367.967-367.985.

nature to fall within the purview of § 365. See, e.g., In re Porterfield, 331 B.R. 480 (Bankr. S.D. Fla. 2005); In re Knowles, 253 B.R. 412 (E.D. Ky. 2000); In re Stellman, 237 B.R. 759 (Bankr. D. Idaho 1999). In the present facts, there is no practical difference whether the Rental Contract is a "true" lease or an "executory" lease. Regardless, the Rental Contract qualifies under the Bankruptcy Code for treatment pursuant to § 365, with all of its attendant rights and requirements for assumption or rejection.[9]

The Court recognizes that treating the Rental Contract under § 365 may appear to be unfair to Mrs. Johnston because whether she assumes the Rental Contract or not, she will have paid more for the Shed then what a creditworthy consumer would pay to a traditional retailer of storage buildings (a difference of $1726.04 based on the "cash price" of the Shed). The Court also recognizes, however, that rent-to-own contracts are often the only alternative to credit sales for those consumers with whom traditional retailers and credit card companies refuse to do business.

Conclusion

Having determined that § 365 governs the Rental Contract, the Court must consider whether the Plan provides it appropriate treatment. The Plan treats Gold Capital as an unsecured creditor, which is not treatment authorized by the Bankruptcy Code. Under the mandates of § 365 and § 1322(b)(7), a plan may provide for the assumption or rejection of any executory contract or unexpired lease. The Plan here does neither and cannot be confirmed for that reason.

IT IS, THEREFORE, ORDERED that the Objection is well taken and is hereby sustained.

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[9] The definition of an executory contract is "[a] contract under which the obligation of both the bankrupt and the counterparty to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Phoenix Exploration, Inc. v. Yaquinto (In re Murexco Petroleum, Inc.), 15 F.3d 60, 63 n.3 (5th Cir. 1994).

IT IS FURTHER ORDERED that the confirmation of the Plan should be and is hereby denied.

IT IS FURTHER ORDERED that the Johnstons shall have 14 days from the date hereof to amend the Plan in light of this opinion.

SO ORDERED.

Dated this the 18th day of February, 2011.

/ s / Neil P. Olack
NEIL P. OLACK
U. S. BANKRUPTCY JUDGE