

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF)	
)	
HAROLD E. FRAIZER,)	
LUCINDA A. FRAIZER,)	CASE NO. BK91-81865
)	
DEBTOR)	A92-8141
)	
FIRST NATIONAL BANK IN OGALLALA,)	
A Nebraska Banking Corporation,)	
)	CH. 12
Plaintiff)	
vs.)	
)	
SCOTT HYDRO-GARDENS, INC.,)	
A Colorado Corporation,)	
)	
Defendant)	

MEMORANDUM

This matter was submitted to the Court on a stipulation of facts, depositions, and briefs. Appearing on behalf of plaintiff was Edward D. Steenburg of McQuillan & Spady, P.C., Ogallala, Nebraska. Appearing on behalf of defendant was Terry Curtiss of Curtiss, Moravek & Curtiss, Alliance, Nebraska. This memorandum contains findings of fact and conclusions of law required by Fed. Bankr. R. 7052 and Fed. R. Civ. P. 52. This is a core proceeding as defined by 28 U.S.C. § 157(b)(2)(K).

Background

The debtors are operating under a confirmed Chapter 12 plan. The plan acknowledges claims of both the plaintiff and the defendant and acknowledges a dispute between the plaintiff and the defendant with regard to the priority of liens on certain equipment used in the operation of the business. The equipment is a greenhouse originally owned by defendant and either leased to or sold to the debtors for use in the business. The document used in the transaction between the debtors and Scott Hydro-Gardens, Inc., is entitled a lease. However, the plaintiff claims that the transaction between the debtor and the defendant was actually a sale and a disguised security agreement which was not perfected under the Uniform Commercial Code. Therefore,

according to the plaintiff, its perfected security interest attached to the greenhouse when the debtors had rights in the greenhouse, and the plaintiff has rights superior to the defendant in the stream of payments payable by the debtors and concerning the greenhouse.

The First National Bank in Ogallala (Bank) brought this declaratory judgment action against Scott Hydro-Gardens, Inc., (Scott) requesting a determination of the rights of the Bank and Scott in the greenhouse and the stream of payments from the debtor.

In 1985 and in 1990, the debtors executed and delivered to the Bank a security agreement and a financing statement which covered equipment and accounts and specifically covered greenhouse equipment then owned by the debtors and after-acquired greenhouses and equipment. The security agreements were properly perfected and continuation statements were filed, as necessary.

On July 7, 1989, Scott entered into an agreement with Harold E. Fraizer, one of the debtors, designated as a lease, regarding the greenhouse. The greenhouse is a building thirty-one feet by one hundred forty-four feet complete with ventilation, wet walls sequence, water timer, Wadsworth Greenhouse Control System, GE Lexan Roof, American Filter Company heat exchanger and blower motor, and other accessories. After execution of the agreement between the debtor and Scott, the debtor paid for the dismantling and moving of the greenhouse from Scott's location to Fraizer's location and then paid for the reassembly on the Fraizer location. The greenhouse is now attached to other greenhouses at the Fraizer business in Keith County, Nebraska.

The debtors eventually filed a Chapter 12 bankruptcy case, and a plan was confirmed which provides that until the Bank and Scott resolve their dispute regarding the priority of their liens all payments made by the debtors concerning the greenhouse shall be retained by the Chapter 12 Trustee.

Legal Analysis

The document in dispute is deposition Exhibit K, entitled "Lease" and dated July 7, 1989. It is between Scott Hydro-Gardens, Inc., and Harold Fraizer d/b/a Tomato King of Big Springs, Nebraska.

For the most part, the law of Nebraska is that whether a lease is a "true lease" or a lease intended as security, and, therefore, subject to the Uniform Commercial Code, depends upon

the intent of the parties. In re Schultz, 63 B.R. 163, 166 (Bankr. D. Neb. 1986).

The statutory provision in effect at the time the document was executed by the parties was Section 1-201(37) of the Nebraska version of the Uniform Commercial Code. That section, in relevant part, states:

. . .Whether a lease is intended as security is to be determined by the facts of each case; however, (a) the inclusion of an option to purchase does not of itself make the lease one intended for security, and (b) an agreement that upon compliance with the terms of the lease the lessee shall become or has the option to become the owner of the property for no additional consideration or for a nominal consideration does make the lease one intended for security.

Neb. Rev. Stat. U.C.C. § 1-201(37) (1980).

The section has been amended and recodified since the execution of the document in question. Changes in the law became effective in 1990. Statutes covering substantive matters in effect at the time of the transactions govern, not later enacted statutes. Norwest Bank v. Bowers, 246 Neb. 83, 516 N.W.2d 623 (1994); Ashland State Bank v. Elkhorn Racquetball, Inc., 246 Neb. 411, ___ N.W.2d ___ (1994).

At least one Nebraska Supreme Court decision has held that if the agreement gives the lessee an option to become the owner of the personal property for nominal consideration, the agreement, as a matter of law, is intended for security. Reyna Fin. Corp. v. Lewis Serv. Ctr., Inc., 229 Neb. 878 (1988), 429 N.W.2d 380. Neither the Reyna opinion nor a similar opinion of the Supreme Court in Crowder v. Allied Inv. Co., 190 Neb. 487 (1973), 209 N.W.2d 141, contain any analysis of the terms of the agreement, the intent of the parties or the facts of the case. They simply rely upon subsection (b) of Section 1-201(37). Those two cases are in contrast to the factual analysis performed by the court in Gibreal Auto Sales, Inc. v. Missouri Valley Mach. Co., 186 Neb. 763 (1971), 186 N.W.2d 719. In the Gibreal case, the court found that the option to purchase required a payment of more than nominal consideration, but in addition, the Gibreal court performed an analysis of the terms of the document itself. 186 Neb. at 766. The court stated:

The amount of consideration at the end of the lease period on the option was substantial. It was not nominal. There was no identification of a property interest in Welty since the plaintiff under the lease agreement could interchange and substitute a new tractor at any time. He was to receive possession and use for a definite period of time, and not indefinitely, and at the end of that period he could become the owner only by paying an amount equal to one-quarter of the total rent already paid. The totality of the circumstances demonstrate that the parties intended the transaction to be that which they said it was, a lease with an option to buy, and not a sale with a purchase money security interest. Therefore, it is clear that the Uniform Commercial Code provisions thereto do not apply. The plaintiff was entitled, as owner, to immediate possession of the vehicle on default of performance of the lease agreement.

Gibreal, 186 Neb. at 766.

The document executed by Fraizer and Scott in July of 1989, whether it is a true lease or a disguised security document, is a contract. The question of whether a lease is a true lease, rather than one intended as security, depends upon the intent of the parties. **Neb. Rev. Stat. U.C.C. § 1-201(37)** (1980) (Whether a lease is intended as security is to be determined by the facts of each case;). In re Schultz, 63 B.R. 163, 166 (Bankr. D. Neb. 1986); American Standard Credit v. Nat'l. Cement Co., 643 F.2d 248, 266 (5th Cir. 1981).

It is the law of Nebraska that when the provisions of a contract, together with the facts and circumstances that aid in ascertaining the intent of the parties are not in dispute, the proper construction of such a contract is a question of law. Meyers v. Frohm Holdings, Inc., 211 Neb. 329, 333, 318 N.W.2d 716, 719 (1982); Mecham v. Colby, 156 Neb. 386, 56 N.W. 299, 304 (1953). The provisions of this contract are not in dispute.

There is only one paragraph in the fifteen paragraph document entitled "Lease" from which one could infer that the document is anything but a true lease. That paragraph is number 7 which is the option to purchase. Every other paragraph in the document that has any relevance to the issue of whether or not the document is a true lease includes language from which one could only conclude that it is a true lease. For example, the

title of the document is "LEASE." The introductory paragraph says, "This lease made" The first numbered paragraph states: "Owner leases to Lessee, and Lessee rents from Owner" The second numbered paragraph states:

The term of this Lease shall commence February 1, 1990, and terminate January 31, 1995, PROVIDED, HOWEVER, that Lessee may take possession of the leased property and move it from its present location to Lessee's site near Big Springs, Nebraska, at any time following the execution hereof.

The third numbered paragraph is entitled "(Rent)." It states: "Lessee shall pay rent to Owner for the leased property during the term of the Lease in the total amount of [A]ll monthly rental payments shall be paid to Owner at Owner's residence or elsewhere as Owner may direct in writing."

Numbered paragraph 4 referring to taxes once again talks about the "leased property" and provides that the "Lessee" shall pay those taxes.

Numbered paragraph 5 refers to lessee bearing the risk of loss concerning the leased property and consistently refers to Fraizer as the lessee and Scott as the owner.

Numbered paragraph 6 is similar concerning possession, location and use. In addition, numbered paragraph 6 provides that not only will the lessee use the property in the manner intended and maintain it, but the owner shall have the right to inspect the leased property at any reasonable time and to fix evidence of ownership.

In numbered paragraph 8, the language of the document provides that the lessee shall indemnify the owner during the possession of the property by the lessee.

Numbered paragraph 9 provides that neither party may assign an interest in the "Lease" nor grant, convey or otherwise pledge the leased property as security.

Numbered paragraph 10 leaves title to the leased property in the owner. It specifically provides that the leased property, if and when placed on the lessee's real estate, shall not become a fixture and provides that in the event of default the property may be removed by the owner.

Numbered paragraph 11 concerns representations and warranties by the lessee and the lessor.

Numbered paragraph 12 concerns default and the rights and remedies of the parties upon default.

Numbered paragraphs 13 and 14 also contain specific references to the leased property, the lessee and the lessor.

Several of the paragraphs contain terms which are as equally consistent with a true lease as with a purchase and disguised security agreement. These terms include the requirement that the lessee insure the equipment; that the risk of loss is on the lessee; that the lessee is required to pay for taxes, repairs and maintenance; that upon default the obligation is accelerated; and that warranties generally found in a lease are excluded by the agreement. None of these factors, individually or collectively, are conclusive or primary with regard to determining the intent of the parties because those types of terms can appear in both true leases and purchases and disguised security agreements. In re Schultz, 63 B.R. 163, 167 (Bankr. D. Neb. 1986). See also In re Loop Hosp. Partnership, 35 B.R. 929 (Bankr. N.D. Ill. 1983).

As mentioned above, only one paragraph in the document is indicative of a lease intended for security rather than a true lease. That is paragraph 7, which contains the option. It states:

7. (Option to Purchase) Upon payment of all rental due hereunder, Lessee may elect to become the Owner of the leased equipment without further payment to Owner, and upon exercise of this election, Owner shall execute and deliver to Lessee a bill of sale transferring the leased property to Lessee, free and clear of liens.

Reading paragraph 7 along with all of the other paragraphs of the document, one is not provided a hint that this document is anything other than a true lease. The true lease/security question only arises when one pulls paragraph 7 out of context and narrowly reads that portion of the Nebraska U.C.C. § 1-201(37) which, on the one hand states that whether a lease is intended as security is to be determined by the facts of each case and, on the other hand, at sub-paragraph (b) states that if a purported lease agreement contains a provision which allows the lessee to become the owner of the property for no or nominal consideration, the lease is one intended for security. **Neb. Rev. Stat. U.C.C. § 1-201(37)** (emphasis added). The Nebraska Supreme

Court cases cited above, including Reyna Financial Corp., and Crowder, appear to only look at the single paragraph in the questioned document which contains the option to purchase for no or nominal consideration and conclude that the document must be intended for security.

With all due respect to the Nebraska Supreme Court, when attempting to interpret the intent of the parties to an agreement, it is not appropriate to consider only one paragraph and ignore the balance of the agreement.

The Eighth Circuit Court of Appeals, as recently as 1993, when affirming a decision by the United States District Court for the District of Nebraska, although applying Delaware contract law, stated that the contract must be interpreted as a whole and the court must read a particular section in the context of the whole agreement. Rafos v. Outboard Marine Corp., 1 F.3d 707, 709 (8th Cir. 1993). The court, quoting Delaware law, stated:

The guiding principles have been stated as follows in a leading Delaware decision: "The basic rule of contract construction gives priority to the intention of the parties. In upholding the intentions of the parties, a court must construe the agreement as a whole, giving effect to all provisions therein. Moreover, the meaning which arises from a particular portion of an agreement cannot control the meaning of the entire agreement where such inference runs counter to the agreement's overall scheme or plan."

Id. at 709 (quoting E.I. duPont de Nemours & Co. v. Shell Oil Co., 498 A.2d 1108, 1113 (Del. 1985) (en banc) (citations omitted)).

Nebraska law does not appear to differ from Delaware law regarding how one should determine the intent of the parties to a contract.

The document, by its own terms, when reading each section in the context of the whole agreement, reflects the intent of the parties that it be treated as a true lease. The words used in every paragraph, the title, the term of possession, right of the owner to affix his ownership interest to the equipment, the right of the owner to inspect the equipment, the right of the owner to repossess on default, the requirement that payments be made monthly in advance, the prohibition on assignment or pledge for security, the provision that prohibits the property from becoming

a fixture, all lend credence to the position of Scott that the document was intended as a true lease.

In addition to the document itself, the parties presented deposition testimony of Mr. Fraizer and the president of Scott. Both testified, consistent with the language of the document, that the document was intended as a lease. They were both aware that the useful life of the equipment might exceed the term of the lease. They were also both aware that the value of the property at the end of the lease was unable to be determined at the time the lease was entered into. Whether such value would be in excess of the total rental payments would depend upon the condition of the property at the end of the term and the market for the agricultural product, tomatoes, being raised in the equipment. From such testimony, the court can conclude that it is just as possible that the value of the property at the end of the term of the lease would be close to nominal as it is possible that the value of the property at such time would be far in excess of a nominal value.

In addition to the above testimony, the representative of Scott testified, consistent with the position that the document was intended as a true lease, that Scott, as owner, continued to depreciate the equipment on tax returns and treated the monthly payments received from Fraizer as rent income.

Mr. Fraizer testified that he originally desired to purchase the equipment and Scott desired to sell it. Mr. Fraizer went to his operating lender, the plaintiff in this case, and requested that the lender finance the purchase of the equipment. The lender refused. Mr. Fraizer wanted to use the greenhouse to expand his production capacity and so he and Scott negotiated the terms of a lease, which would permit such use. Scott was not in the finance business. Scott had been in the same business as Fraizer, the business of growing tomatoes hydroponically within a greenhouse setting.

This Court concludes as a matter of law that the agreement between Fraizer and Scott was intended by the parties to be, and is, a true lease.

Parol Evidence

Independent of the above analysis and conclusion, the Court also finds that the document is a true lease because the option language which appears to create a lease intended for security was included in the document by mistake.

Testimony was presented by deposition over a parol evidence objection by the plaintiff, that both Mr. Fraizer and Scott intended that the option to purchase contained in the agreement actually would require, at the end of the lease term, a negotiation between the parties with regard to the value of the property and, perhaps, a further payment by Fraizer to Scott for a transfer of ownership. Both parties, Fraizer and Scott, testified that paragraph 7 did not reflect their intention and both were surprised at the language contained in paragraph 7.

Parol evidence is admissible if there is proof of fraud, mistake or ambiguity. Five Points Bank v. White, 231 Neb. 568, 437 N.W.2d 460 (1989). The written document is the only competent evidence of the contract, absent proof of fraud, mistake, or ambiguity. Paris v. Crawford State Bank, 2 Neb. App. 12 (1993).

The document itself is not ambiguous and there is no evidence of fraud. On the other hand, testimony of the lessor, Scott, and the lessee, Mr. Fraizer, although fitting the description of parol evidence, is certainly admissible, if clear, convincing and satisfactory, to overcome the presumption that the written instrument correctly expresses the intention of the parties. Jelsma v. Acceptance Ins. Co., 233 Neb. 556, 446 N.W.2d 725 (1989). In an action for reformation of a contract, the Nebraska Supreme Court has ruled that if the evidence of the true intent of the parties is clear, convincing, and satisfactory, and the evidence establishes that the mutual mistake involved is common to both parties, with each laboring under the same misconception, reformation may be decreed. Nat'l. Am. Ins. Co. v. Continental W. Ins. Co., 243 Neb. 766, 773, 502 N.W.2d 817 (1993). (citations omitted). Also, in Stuart Trucking, Inc. v. PBX, Inc., 238 Neb. 958, 473 N.W.2d 123 (1991) the Nebraska Supreme Court stated:

As we expressed in Newton v. Brown, 222 Neb. 605, 613, 386 N.W.2d 424, 430 (1986): "If incorrect language or wording is inserted by mistake, including a scrivener's mistake, into an instrument intended to reflect the agreement of the parties, such mistake is mutual and contrary to the real intention and agreement of the parties."

238 Neb. at 965. If such a mutual mistake occurs, the Nebraska Supreme Court has ruled that a party was entitled to reformation of the document. Id.

In the case before this Court, Mr. Fraizer has testified, against his own interest, that there was a mutual mistake with regard to the option to purchase. The representative of Scott has testified to the same effect. If this action had been brought by either Mr. Fraizer or Scott to reform the contract to reflect the intent of the parties, the testimony of the parties is sufficiently clear, convincing and satisfactory to permit a court to reform the contract to reflect the actual intent. If such reformation occurred, the option paragraph, number 7, would not contain the language which, as a result of the application of U.C.C. § 1-201(37), would permit one to construe the document as a lease intended for security.

Although this is not an action in equity to reform the contract, it is clear that the option language in paragraph seven does not reflect the intent of the parties to the contract, and is the result of mutual mistake. Since the option language was mistakenly inserted in the document, U.C.C. § 1-201(37) should not apply to require the Court to deem the lease one for security.

Conclusion

1. The document, as a matter of law, is a true lease.
2. The document is not a lease intended for security because the option to purchase was included in the document by mistake.
3. The rights of Scott in the equipment and the stream of payments from the debtor have priority over any claim of plaintiff bank.

Separate journal entry to be entered.

DATED: August 5, 1994.

BY THE COURT:

/s/ Timothy J. Mahoney
Timothy J. Mahoney
Chief Judge

Copies faxed by the Court to:
WOOD, W. ERIC 392-1011

Copies mailed by the Court to:
Edward Steenburg, 201 East Second St., Suite B, Ogallala, NE
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Terry Curtiss, P.O. Box 460, Alliance, NE 69301

Richard Lydick, Chapter 12 Trustee

Movant (*) is responsible for giving notice of this journal entry to all other parties (that are not listed above) if required by rule or statute.

UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF)	
HAROLD E. FRAIZER,)	CASE NO. BK91-81865
LUCINDA A. FRAIZER,)	A92-8141
<u>DEBTOR(S)</u>)	
FIRST NATIONAL BANK IN)	
OGALLALA, A Nebraska)	CH. 12
Banking Corporation,)	
Plaintiff(s))	
vs.)	<u>JOURNAL ENTRY</u>
)	
SCOTT HYDRO-GARDENS, INC.,)	
A Colorado Corporation,)	
)	DATE: August 15, 1994
<u>Defendant(s)</u>)	

APPEARANCES

Edward D. Steenburg, Attorney for plaintiff
Terry Curtiss, Attorney for defendant

IT IS ORDERED:

1. The document, as a matter of law, is a true lease.
2. The document is not a lease intended for security because the option to purchase was included in the document by mistake.
3. The rights of Scott in the equipment and the stream of payments from the debtor have priority over any claim of plaintiff bank.

See memorandum entered this date.

DATED: August 5, 1994.

BY THE COURT:

/s/ Timothy J. Mahoney
Timothy J. Mahoney
Chief Judge

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