

UNITED STATES BANKRUPTCY COURT  
SOUTHERN DISTRICT OF ALABAMA

In Re

NADIA GRAYSON

Case No. 02-15985-MAM-13

Debtor.

**ORDER SUSTAINING RENT-A-CENTER'S OBJECTION TO CONFIRMATION  
AND FINDING THAT AGREEMENTS ARE EXECUTORY CONTRACTS THAT  
DO NOT CREATE SECURITY INTERESTS**

Gregory M. Friedlander, Mobile, Alabama, Attorney for Nadia Grayson  
Gregory B. McAtee, Mobile, Alabama, Attorney for Rent-A-Center Store #A15

This matter is before the Court on Rent-A-Center Store #A15's ("RAC") objection to the confirmation of Nadia Grayson's chapter 13 bankruptcy plan as well as Grayson's motion requesting that the Court interpret various "rental purchase agreements" to determine if the agreements created leases or security interests. The Court has jurisdiction to hear this matter pursuant to 28 U.S.C. §§ 157 and 1334 and the Order of Reference of the District Court. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2) and the Court has the authority to enter a final order. For the reasons indicated below, the Court finds that the agreements are executory contracts that do not create security interests; accordingly, RAC's objection to confirmation is sustained and Grayson's motion to interpret the agreements as unsecured security agreements is denied.

**FACTS**

Nadia Grayson entered into three separate "rental purchase agreements" with RAC during the months of September and October 2002. The agreements are virtually identical with only the description of property, term, and payment amount varying in each one. The payment terms describe the first month's payment as the "initial payment;" payments received thereafter

are described as “renewal payments” because the “lessee” is not required to renew the agreement beyond the first month. The agreements state that RAC is responsible for making all normal repairs during the term of the agreements. They further state that they are rental transactions even though they give the “lessee” the option of acquiring ownership by doing nothing more than making all the payments.

Grayson filed a chapter 13 petition on October 21, 2002, slightly more than one month after entering into the first agreement with RAC. Though RAC’s agreements state that they are rental transactions, Grayson listed RAC as a secured creditor in the amount of \$300.00 and as an unsecured creditor in the amount of \$2,700.00 in her schedules. RAC filed an objection to the confirmation of Grayson’s chapter 13 plan, listing various grounds under § 1325 of the Bankruptcy Code. Subsequently, Grayson filed a motion requesting that the Court interpret the three agreements she has with RAC to determine if the agreements created leases or security interests.

The Court held a hearing on January 8, 2003 regarding RAC’s objection to confirmation as well as Grayson’s motion for interpretation of the three agreements. RAC argued that the agreements created true leases which must be assumed or rejected; Grayson argued that the agreements created security interests which allows her to treat RAC as an undersecured creditor under her plan.

#### LAW

At issue in this case is whether the three separate agreements between Grayson and RAC created a lease which may be assumed or rejected, or whether they created security interests in the collateral which allows Grayson to treat RAC as an undersecured creditor under her plan.

Whether an agreement creates a lease or security interest is governed by state law. *See Butner v. United States*, 440 U.S. 48 (1978). The parties submitted the agreements and presented written and oral arguments to support their respective positions; the parties argued that two different Alabama state statutes purporting to regulate the transactions in this case were applicable. The statutes are Ala. Code § 8-25-1 and Ala. Code § 7-1-201(37).

The Court has held under a previous version of Alabama's Uniform Commercial Code (UCC) that rent-to-own agreements qualify as executory contracts under the Bankruptcy Code. *In re Copeland*, Case No. 95-12487-MAM-13 (Bankr. S.D. Ala. 1996). The *In re Copeland* decision closely followed the result reached in *In re Trusty*. 189 B.R. 977 (Bankr. N.D. Ala. 1995). Although the Alabama legislature has enacted a new version of the UCC, the classification of rent-to-own contracts as executory contracts under the Bankruptcy Code is unchanged.

The Court still agrees with the *In re Trusty* decision, holding that a rent-to-own contract is not a pure "lease." It is a "hybrid commercial device created by the Alabama Legislature for a distinctive exchange of particular types of property." *Trusty* at 981. The Court will therefore speak in terms of "executory contracts" and not "leases" when dealing with the agreements in the bankruptcy context. The rent-to-own agreements are executory contracts and are treated as that under the Bankruptcy Code. *Id.* However, state law deems rent-to-own contracts as leases so the Court will use that term when discussing the state law implications of the rent-to-own agreements.

The parties disagree about the application of Ala. Code §§ 8-25-1 and 7-1-201(37) to the agreements. To determine which statute applies and whether it makes any difference, the Court

must look at the following:

1. Is this dispute governed by Alabama's rental purchase agreement statute or by Alabama's version of the Uniform Commercial Code (UCC)?
2. What is the result under the governing Alabama state statute?

1.

Is This Dispute Governed by Alabama's Rental Purchase Agreement Statute or by Alabama's Version of the UCC?

Under the Bankruptcy Code, the issue of whether a transaction creates an executory contract versus a security interest "depend[s] on whether it constitutes a security interest under applicable state or local law." *Rent-A-Center v. Shelby (In re Shelby)*, 127 B.R. 682, 686 (Bankr. N.D. Ala. 1991). Accordingly, Alabama state law must be used to determine if the transactions at issue here created executory contracts or security interests.

The parties disagree regarding two separate and seemingly mutually exclusive state statutes, Ala. Code § 7-1-201(37) and Ala. Code § 8-25-1, each of which contains language regulating the type of agreement at issue in this case.

The relevant portion of Ala. Code § 8-25-1 states:

(5) RENTAL-PURCHASE AGREEMENT. An agreement for the use of merchandise by a consumer for personal, family, or household purposes, *for an initial period of four months or less that is automatically renewable with each payment after the initial period, and that permits the consumer to become the owner of the merchandise.* This term does not include any transaction wherein a consumer sells personal property to a merchant and then leases the same personal property back with or without a right to repurchase the property. *Any rental-purchase agreement in compliance with this chapter shall not be construed to be, nor governed by the laws relating to:*

- a. A "credit sale" as that term is defined in subdivision (4) of Section 5- 19-1; or
- b. A "security interest" as that term is defined in subdivision (37) of Section 7-1 -201 of the Uniform Commercial Code.

Ala. Code § 8-25-1 (emphasis added).

The relevant portion of Ala Code § 7-1-201(37) states:

- b. 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
1. the original term of the lease is equal to or greater than the remaining economic life of the goods, or
  2. 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, or
  3. 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
  4. 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.
- c. A transaction does not create a security interest merely because it provides that:
1. the 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,
  2. 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,
  3. *the lessee has an option to renew the lease or to become the owner of the goods*,
  4. 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
  5. 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.

Ala. Code § 7-1-201(37) (emphasis added).

Under the three agreements Grayson entered into with RAC, the term of the agreements ranged from 14.3 months to 28.1 months; if Grayson made all the payments under agreements, she would obtain ownership of the property. However, Grayson was not required to renew the

agreements beyond the first month. She could terminate the agreements by returning the property in good condition to RAC at the end of any one month period.

The agreements were “for an initial period of four months or less,” they were “automatically renewable with each payment after the initial period,” and they permitted Grayson “to become the owner of the merchandise.” Accordingly, the agreements appear to be regulated by Ala. Code § 8-25-1. Additionally, because Grayson had the option to either terminate the rental payments at any time or “to renew the lease or to become owner of the goods,” the agreements appear to be regulated by Ala. Code § 7-1-201(37).<sup>1</sup> The Court finds that the result in this case is the same no matter which statute is applied; the agreements created executory contracts which Grayson must assume or reject under § 365 of the Bankruptcy Code. However, because this is an important issue that frequently arises under Alabama law, the Court will continue its analysis of which statute governs these transactions.

Alabama’s statutory scheme of having two separate statutes that each contain language regulating the same type of transaction is confusing. The language in Ala. Code § 8-25-1 seems to resolve the issue of which statute controls because it purports to exclusively regulate transactions, such as the ones here, that fall within its definition of a rental purchase agreement. It states “[a]ny rental-purchase agreement in compliance with this chapter shall not be construed to be, nor governed by the laws relating to . . . [a] ‘security interest’ as that term is defined in subdivision (37) of Section 7-1-201 of the Uniform Commercial Code.” Ala. Code § 8-25-1.

The language in Ala. Code § 8-25-1 removing certain rental purchase agreements from

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<sup>1</sup> Technically, the term “lease” does not apply to these agreements in the bankruptcy context. However, in the state law context, that term is used to cover rent-to-own agreements. See Ala. Code § 8-25-1(2) and (4) for example; *In re Trusty* at 981 n.6.

regulation under Ala. Code § 7-1-201(37) was added in the 1991 amendment to both statutes. It was a response to the result reached in the *In re Shelby* case, *supra*, in which the Bankruptcy Court for the Northern District of Alabama held that rental purchase agreements created security interests under Ala. Code § 7-1-201(37). *In re Trusty* at 981. The legislative history of Ala. Code § 8-25-1 states that the Alabama legislature amended the language of Ala. Code §§ 8-25-1 and 7-1-201(37) “relating to rental-purchase agreements and the Alabama Uniform Commercial Code, so as to exclude such agreements from coverage of the Alabama Uniform Commercial Code provisions relating to security interests and to authorize certain practices by rental-purchase merchants.” Act 91-654, S.B. No. 96 (Ala. 1991).

The present version of Ala. Code § 7-1-201(37) was enacted as part of Alabama’s new Article 9 of its UCC, which was adopted in 2001. It begins by generally stating “[w]hether a transaction creates a lease or security interest is determined by the facts of each case;” it then specifically states that “[a] transaction does not create a security interest merely because it provides that . . . the lessee has an option to renew the lease or to become the owner of the goods.” Ala. Code § 7-1-201(37). When it enacted the present version of Ala. Code § 7-1-201(37), the Alabama legislature did not include the language contained in the prior version of Ala. Code § 7-1-201(37), which specifically excluded certain rental purchase agreements from its coverage; however, the legislature failed to remove the same language from Ala. Code § 8-25-1. Therefore, according to its terms, Ala. Code § 8-25-1 still specifically excludes certain rental purchase agreements from coverage under Ala. Code § 7-1-201(37) of Alabama’s UCC.

After outlining the current statutory scheme regarding rental purchase agreements, the Courts finds the confusion of the parties regarding the application of Ala. Code §§ 8-25-1 and 7-

1-201(37) to the issue in this case is understandable. When Ala. Code § 8-25-1 is construed along with Ala. Code § 7-1-201(37), the former section appears to exclude regulation under the latter. However, the Court finds that the policy behind Alabama's enactment of these two statutes calls for Ala. Code § 7-1-201(37) to be controlling in this case.

Although there have been various changes to Ala. Code § 8-25-1 as well as changes to Ala. Code § 7-1-201(37), “the clear intent of the Alabama legislature . . . has never changed;” its policy has always been that “rent-to-own agreements do not create security agreements and are not sale contracts.” *In re Trusty* at 981. The legislature amended Ala. Code §§ 8-25-1 and 7-1-201(37) in 1991 to remove certain rental purchase agreements from coverage under its UCC because under that version of the UCC such agreements created security interests. Act 91-654, S.B. No. 96 (Ala. 1991). The legislature subsequently adopted the new version of Article 9 as part of its UCC; it contains a revised definition of “security interest” under which rental purchase agreements create leases rather than security interests. Ala. Code § 7-1-201(37).

The Court finds that the language in Ala. Code § 8-25-1 specifically excluding rental purchase agreement from coverage under the UCC is no longer necessary because the UCC statute, Ala. Code § 7-1-201(37), regulates these agreements in accordance with the intent of the Alabama legislature. The Court must apply the UCC's provisions “liberally” in an effort “to promote its underlying purposes and policies.” Ala. Code § 7-1-102(1). The UCC statute, Ala. Code § 7-1-201(37), displaces Ala. Code § 8-25-1 for the purpose of determining whether a transaction creates a lease or a security interest. With the enactment of the new UCC statute, the rental purchase agreement statute, Ala. Code § 8-25-1, is relegated to use as a disclosure statute only.



The Court finds that this is the only reasonable construction of the two statutes because it allows for “simultaneous adherence” to both statutes in a manner that does not “offend, encumber, or repeal” one statute at the expense of the other. *See In re Burton*, 128 B.R. 807, 811-12 (Bankr. N.D. Ala. 1989). Both statutes are “completely capable of peaceful co-existence” and the Court will not construct them in a manner that denies effect to either statute. *Burton* at 812. Accordingly, the Court finds that Ala. Code § 7-1-201(37) governs the determination under state law of whether the transactions at issue in this case created leases or security interests.

2.

What is the Result Under the Governing Alabama State Statute?

The Court has found that Ala. Code § 7-1-201(37) is the governing Alabama state statute used to determine if the transactions at issue in this case created leases or security interests. Under Ala. Code § 7-1-201(37), the finding of “[w]hether a transaction creates a lease or security interest is determined by the facts of each case;” but “[a] transaction does not create a security interest merely because it provides that . . . the lessee has an option to renew the lease or to become the owner of the goods.” Ala. Code § 7-1-201(37).

Grayson’s agreements with RAC provide that she has the option to renew the “lease” and to become owner of the goods. She also has the option to terminate the agreements at the end of any month. Grayson’s three agreements with RAC do not fall under the explicit definition of what *does* constitute the creation of a “security interest” under Ala. Code §7-1-201; her agreements do fall under the explicit definition of what *does not* constitute the creation of a “security interest” though. Therefore, the Court can only find that her agreements constitute the

creation of a “security interest” if the specific facts of her case so dictate. The Court finds that there is nothing in Grayson’s agreements with RAC to indicate that security interests were created. Accordingly, the Court holds that Grayson’s agreements with RAC created true leases which are executory contracts under the Bankruptcy Code; she must now assume or reject them in her chapter 13 bankruptcy plan.

It is ORDERED that Rent-A-Center Store #A15's objection to the confirmation of Nadia Grayson’s chapter 13 bankruptcy plan is SUSTAINED because her three agreements with Rent-A-Center were leases under state law which must be assumed or rejected as executory contracts under her plan.

It is FURTHER ORDERED that Grayson’s motion to interpret the agreements as unsecured security agreements is DENIED because the agreements are leases under state law.

It is FURTHER ORDERED that Nadia Grayson shall file an amended plan by February 7, 2003 and a hearing on the amended plan be held on March 10, 2003 at 1:00 p.m.

Dated: January 23, 2003

/s/ Margaret A. Mahoney  
MARGARET A. MAHONEY  
CHIEF BANKRUPTCY JUDGE