Not intended for publication

Dated: April 20, 2005
The following is SO ORDERED.

G. Harvey Boswell
UNITED STATES BANKRUPTCY JUDGE

UNITED STATES BANKRUPTCY COURT
WESTERN DISTRICT OF TENNESSEE
EASTERN DIVISION

In re	
JOHNNY MCGUIRE	**Case Number 05-10464**
Debtor.	**Chapter 13**
JOHNNY MCGUIRE,	
Plaintiff	
v.	**Adv. Pro. No. 05-5052**
ABLES INVESTMENTS, LLC,	
Defendant.	

MEMORANDUM OPINION AND ORDER RE: COMPLAINT TO DETERMINE VALIDITY AND EXTENT OF INTEREST IN PROPERTY OF THE ESTATE

The Court conducted a trial on the debtors' complaint to determine validity and extent of interest in property of the estate on March 4, 2005. FED . R. BANKR. P. 7001, et seq. Pursuant to 28 U.S.C. § 157(b)(2), this is a core proceeding. After reviewing the testimony from the trial and the record as a whole, the Court makes the following findings of facts and conclusions of law. FED. R. BANKR. P. 7052.

I. FINDINGS OF FACT

This case revolves around a lease purchase agreement entered into by the parties in March 2003. The facts are relatively clear-cut and not in dispute. In early 2003, Johnny and Trudy McGuire, ("debtor" or "McGuire") located a house in Newbern, Tennessee, that they were interested in purchasing. The McGuires were not able to obtain financing for the house on their own and the real estate agent referred them to Bill

Ables of Ables Investments, LLC, ("Ables"). Ables met with the McGuires and agreed to come to the auction of the house in Newbern, bid on it for them, and then lease the property to them under a lease purchase agreement.

In order to effectuate the agreement between the parties, the McGuires agreed to pay Ables $5000.00 prior to the auction. Both the Ables and the debtor agreed at the trial in this matter that the $5,000.00 would be treated as a down payment on the house. Ables testified that had the debtor and his wife not made the $5,000.00 payment, the monthly payment under the agreement would have been higher. After receipt of the $5,000.00, Ables agreed to attend the auction and bid on the house up to $50,000.00.

At the auction, Ables was the high bidder for the house and paid a purchase price of $48,500.00. After the inclusion of various fees, Ables paid the auctioneer a little over $50,000.00 for the house. Ables used the $5,000.00 the McGuires had given to him prior to the auction and financed the remaining $43,500.00 with Security Bank.

After the property was purchased, the McGuires entered into a Lease Purchase Agreement with Ables. The agreement provided that the "Lessor [Ables] hereby leases to the Lessee [Johnny and Trudy McGuire] that property owned by the Lessor located at 955 Dr. Hall Rd. In Newbern, TN." The agreement was for a period of fifteen years beginning March 1, 2003, and terminating on April 30, 2018. Pursuant to the terms of the agreement, the McGuires agreed to pay $455.00 per month "for use of the property." Upon payment of the final lease payment, Ables agreed to convey the property by deed to the McGuires for $100.00.

In addition to making the monthly payment, the McGuires agreed "to pay all taxes, assessments and charges of every kind now or hereafter assessed or levied . . . during the life of this agreement" and to keep the property free of any type of liens. The McGuires also agreed to pay the insurance premiums on the property. Should any repairs or improvements be necessary during the term of the agreement, the McGuires consented to being responsible for them.

Pursuant to the terms of the agreement, if the payments were more than sixty days in arrears:

> [T]he Lessor, at this option, may rescind this contract and take full and immediate possession of the property described herein. In the event of such recission, [sic] all payments made to date by the Lessees will be taken and retained by the Lessor, not as a penalty, but to be considered payment for use of said property from the date of this agreement to the date of recission [sic].

Exhibit 1, "Lease Purchase Agreement." The agreement further provided that:

> If the Lessee breaches the terms of this agreement, then a notice of forfeiture may be given by depositing said notice in the United States Mail, contained in a sealed envelope, with postage prepaid, addressed to the Lessees at the address of the property described herein. Before forfeiture shall take place, Lessees shall have 10 days from the postmarked date of

> said written notice of the exact nature of the breach, and only upon failure to comply to such written notice, shall forfeiture be declared. Upon receiving such notice, Lessee agrees to immediately vacate the described premises and to leave said premises in good condition, less normal wear and tear.

Exhibit 1, "Lease Purchase Agreement." The parties signed the agreement on March 3, 2003 and Ables recorded it in the Register's office for Dyer County on the same day. Although the parties agreed that the money the McGuires paid to Ables prior to the purchase of the house was to be considered a down payment, the agreement does not mention the $5,000.00.

McGuire and his wife made the monthly payments on the house on time for the first few months of the contract; however, at some point they fell behind by three or four months. The McGuires eventually caught that arrearage up and made the subsequent payments on time. Although the agreement stated that the McGuires were to make the insurance payments to Ables, McGuire talked with Ables and told him he thought he could get cheaper insurance on his own. Ables agreed to let McGuire get insurance on his own and McGuire made the payments directly to the insurance company. McGuire listed Ables and Security Finance as "mortgagees" on the policy. During this time, the McGuires also made the property tax payments on the property.

According to the debtor's trial testimony, his wife inherited between $15,000.00 and $30,000.00 sometime after entering into the lease purchase agreement with Ables. At the trial, McGuire alleged that they used $15,000.00 of that money to do work to the Newbern house. McGuire also alleged that the work they did on the house improved the value significantly. The debtor did not produce any evidence of the money spent or the work done to the house nor did he present any proof of the increase in value to the house. The debtor merely testified that he had recently received an offer on the house for $43,500.00 and that the tax role shows a value of "fifty something." Ables admitted at the trial that he has not been back to the Newbern house since he purchased it at the auction in 2003; therefore, he could not dispute the debtor's claims that he has improved the property.

During the summer of 2004, the debtor and his wife separated and Trudy McGuire moved out of the house. Johnny McGuire made the September 2004 payment, but his check was returned for insufficient funds. McGuire then failed to make the October 2004 payment on the house by the due date. As a result, Ables had his attorney, William Jordan, send the McGuires a letter on October 22, 2004, informing them that they were in default under the terms of the lease purchase agreement. Jordan further stated that Ables was making a demand on the McGuires for the October and November 2004 rent plus $125.00 in late charges. If the McGuires tendered $1,035.00 by November 10, 2004, Ables would declare the agreement to be in good standing.

On November 9, 2004, McGuire remitted the funds necessary to cover September's bounced check as well to pay part of the October payment; however, he did not make the November payment. McGuire also failed to make the premium payment on the property insurance that was due in November 2004. Ables received a cancellation notice from the insurer effective November 22, 2004, informing him that the insurance on the property was being cancelled for non-payment. Pursuant to the terms of the mortgage Ables had taken out when purchasing the Newbern property at auction in 2003, Ables was required to maintain insurance on the property. As a result, Ables had to secure an insurance policy on the house once he received the cancellation notice from McGuire's insurer. This policy cost Ables $720.00.

Due to the default in payments and the cancellation of McGuire's insurance policy, Ables sent the McGuires a letter on November 23, 2004, informing them that they were in default under the lease purchase agreement. The McGuires owed Ables $195.00 plus late fees for the October payment and $455.00 plus late fees for the November payment. Ables stated in the letter that "this letter shall serve as your notice of forfeiture." Ables gave the McGuires ten days from the date of the letter to pay the outstanding rent as well as to reimburse Ables the $720.00 for the insurance policy. According to the terms of the letter, failure to make these payments would result in Ables declaring forfeiture of the agreement.

The McGuires did not comply with Ables default notice, nor did they make any more of the monthly payments. On January 12, 2005, Ables sent another letter to the McGuires. This letter stated:

> Since you failed to remedy the deficiencies outlined in my letter of November 23, 2004, I am hereby declaring forfeiture under the Lease Purchase Agreement. Please immediately vacate the premises and leave the premises in good condition.

Exhibit 4, Letter dated January 12, 2005 from Ables Investments, LLC, to Johnny and Trudy McGuire. Despite Ables' demand that they vacate the premises, McGuire did not move out of the house. McGuire was eventually served with a detainer warrant and appeared in court on January 26, 2005. For reasons not explained to this Court, the detainer warrant hearing was continued until February 9, 2005, at which time an order was issued to remove McGuire from the Newbern house.

After the first hearing on the detainer warrant, but prior to the February 9, 2005, hearing, McGuire filed his chapter 13 petition. The case was filed on January 31, 2005. McGuire listed the Newbern property on his Schedule A as "Lease property LTD located @ 955 Dr. Hall Rd., Newbern, TN." McGuire claimed an exemption in the property on Schedule C under TCA § 26-2-301. McGuire listed the property on this schedule as "Lease property LTD located @ 955 Dr. Hall Rd., Newbern, TN," with an exemption value of $5,000.00 and a current market value of $54,000.00. McGuire also listed Ables Investments on his Schedule D with the same description of "Lease property LTD located @ 955 Dr. Hall Rd., Newbern, TN," with a

market value of $54,000.00 and a claim value of $46,000.00. The debtor did not list the agreement on his Schedule G, "Executory Contracts and Unexpired Leases."

In his chapter 13 plan filed on January 31, 2005, McGuire listed the agreement with Ables as a long term secured claim. McGuire designated the claim as a "Lease/Purchase" and proposed in his plan to assume the agreement. McGuire listed the value of the claim as $46,000.00 and proposed a monthly payment of $455.00. McGuire also proposed to include an arrearage of $910.00 with monthly payments of $16.00. McGuire stated at the trial that he will include the unpaid taxes in his plan and that he has now obtained insurance on the property.

On February 23, 2005, McGuire filed the instant adversary proceeding against Ables. In his complaint, McGuire asks the Court to determine if the March 2003 "Lease Purchase Agreement" is a true lease or is instead a purchase agreement. He also asks the Court to determine the extent and validity of Ables' lien on the property.

At the trial in this matter, McGuire alleged that by making the $5,000.00 down payment and by investing $15,000.00 in the property, he acquired an equitable interest in the property which cannot be terminated by a mere notice of default and forfeiture. He also alleged that the agreement is more akin to a purchase agreement than a lease. Because of these claims, McGuire asserts that he still had an interest in the house on the date of filing his bankruptcy petition.

In contradiction to McGuire's allegations, Ables asserted that the letter of forfeiture ended his obligation to continue in the agreement and that the debtor did not have a property interest in the house on the day of filing. Ables testified that he informed McGuire prior to executing the lease purchase agreement, that this was not a mortgage, but was instead a land contract. Ables also claims to have told the debtor that if McGuire and his wife made the payments, he would be more than happy to give him a deed at the conclusion of the lease period; however, if McGuire failed to make the payments, Ables would treat the agreement as if McGuire was simply renting the property. When the debtor failed to make the necessary payments, Ables terminated McGuire's rights to the property. Ables further asserted that McGuire's bankruptcy filing did not revive his obligation to convey the property.

At the conclusion of the trial, the Court took the matter under advisement and ordered the debtor to make an adequate protection payment to Ables in the amount of $455.00. The Court ordered the payment to be made by March 8, 2005. According to counsel for the creditor, McGuire did make the payment in the allotted time.

II. CONCLUSIONS OF LAW

What is essentially at issue in this case is whether or not the debtor had a property interest in the Newbern house at the time of filing his bankruptcy petition. Section 541 of the Bankruptcy Code defines "property of the estate" as "all legal or equitable interests of the debtor in property as of the commencement of the case." 11 U.S.C. § 541(a)(1). The question of whether or not something is property of the estate is a federal question; however, the nature and extent of the debtor's interest is determined by looking to state law. *Butner v. United States*, 440 U.S. 48, 55, 99 S.Ct. 914, 59 L.Ed.2d 136 (1979).

In the case at bar, the debtor has alleged that the "lease purchase agreement" he entered into with Ables in March 2003 is not a lease, but is instead a purchase agreement. The Court has conducted an extensive review of Tennessee case law in researching this matter and there does not appear to be a case directly on point. The majority of the published cases dealing with the issue of whether or not something is a true lease or a sales agreement under Tennessee law involve personal property. *In re Celeryvale Transport, Inc.*, 822 F.2d 16 (6th Cir. 1987); *Singer Manufacturing Co. v. Cole*, 72 Tenn. 439 (Tenn. 1880); *Brandt v. Bib Enterprises, Ltd.*, 986 S.W.2d 586 (Tenn. Ct. App. 1998); *Kultura, Inc. v. Southern Leasing Corp.*, 923 S.W.2d 536 (Tenn. 1996); *Messer Griesheim Indus. v. Cryotech of Kingsport, Inc.*, 45 S.W.3d 588 (Tenn. Ct. App. 2001); *United States Fidelity and Guaranty Co. v. Thompson and Green Machinery Co., Inc.*, 568 S.W.2d 821, 825 (Tenn. 1978) (finding three main tests for determining whether or not an agreement is a true lease: (1) whether or not the "so-called lessee is obligated to accept and pay for the property or is obligated only to return or account for the property according to the terms of the lease from which he may be excused only if he exercises his privilege of purchasing it." If the agreement falls into the latter category, it is a true lease; (2) "the intent of the parties is always controlling and is to be ascertained from the whole transaction;" and (3) "whether the payments required of the transferee are in such amounts, spread over such a period of time, and are to be so made that compared with the original value of the property, its depreciation and likely value at the end of the term, that they may be reasonably considered as compensation for the use of the property or, instead, as payments on an absolute obligation for the purchase price, as in a conditional sale.")

The Court was able to find one unpublished decision which discussed the issue of whether or not an agreement titled "lease" was a true lease or was instead a contract of sale for real property. In *Rutherford Builders v. Security Federal Savings and Loan Assoc. of Murfreesboro*, 1987 WL 18959 (Tenn. Ct. App. 1987), Rutherford Builders, ("Rutherford"), purchased a lot in a subdivision in Rutherford County, Tennessee. Rutherford financed this sale by executing a note in favor of Security Federal as well as a deed of trust. The monthly mortgage payment on this note was $580.43. Approximately one year after closing on the purchase, Rutherford entered into an agreement with Don Taylor, ("Taylor"), which was styled "Lease." The parties filed a Lease Abstract in the Register's Office of Rutherford County. Pursuant to the

agreement's terms, Taylor was to pay $10,750.00 at the time of execution and was to make the monthly mortgage payment of $580.43 to Rutherford. Rutherford would then remit the payment to Security Federal. After three years, Taylor could exercise an option to purchase the property by either assuming the Security Federal note or by paying the outstanding balance on the property to Security Federal. In addition to the monthly payments, Taylor paid the real property taxes, purchased insurance on the property, and claimed the tax benefits associated with ownership.

After looking at all the facts in the case, the Tennessee Court of Appeals decided that the agreement entered into between Rutherford and Taylor was not a lease, but was instead a contract of sale:

> [I]t appears that Taylor, after being placed in possession of the premises, exercised all incidence of ownership in that he made the regular mortgage payments, he claimed the various tax benefits associated with ownership and he paid the real property taxes. In addition, he bought insurance covering the demised premises with himself being the loss payee . . . It is obvious to us that this lease agreement was a disguised contract of sale, with the seller, Rutherford Builders, receiving the sum of $10,750.00 at the beginning of the so-called lease, for its equity in the property.

Id. at *2 -3. In making this decision, the Court of Appeals also looked to the parties' intentions with respect to the agreement:

> As stated by the trial judge, the rule of constructions applicable in the case at bar is stated in *Hamblen County v. City of Morristown*, 656 S.W.2d 331 (Tenn. 1983):
>
> > The rule of practical construction is particularly applicable to this case. That rule, long recognized and applied in this jurisdiction, is that the interpretation placed upon a contract by the parties thereto, as shown by their acts, will be adopted by the court and that to this end not only the acts but the declarations of the parties may be considered.

Rutherford, 1987 WL at *4 (citations omitted). It was apparent to the Court of Appeals that Rutherford and Taylor intended the lease-option agreement to be a contract of sale.

Applying the *Rutherford* factors to the case at bar, it is clear that the agreement executed by the parties in March 2003 is not a true lease. After moving into the Newbern house, McGuire exercised the indicia of ownership. He obtained insurance on the property and he agreed to pay "all taxes, assessments and charges of every kind now or hereafter assessed or levied on the property during the life of this agreement. He also assumed the responsibility of making any repairs or improvements to the property.

In addition to these factors, the undisputed proof presented at the trial in this matter established that McGuire and Ables intended the agreement to be a contract for sale of the property. McGuire testified that he was unable to obtain traditional financing for the purchase of the house and was referred to Ables for the sole purpose of getting help in acquiring the property. Ables agreed to purchase the house at auction for the McGuires. Both Ables and McGuire testified that the $5,000.00 the McGuires paid prior to the auction was a

down payment on the house. Also, the parties provided that at the conclusion of the "lease" term, Ables would deed the property to the McGuires for the sum of $100.00. The Court finds that this nominal sum is strong evidence of the parties' intention that this agreement was a contract for sale and not a lease.

In the case of *In re Carson*, 286 B.R. 645 (Bankr. E.D. Tenn. 2002), Judge Stair discussed the validity of contracts for the sale of real property in Tennessee:

> Even though not widely used, Tennessee does recognize contracts for deed as valid options for the purchase of real property. *See e.g., McMillan v. Am. Suburban Corp*., 136 Tenn. 53, 188 S.W. 615 (1916); *Harmon v. Eggers*, 699 S.W.2d 159 (Tenn.Ct.App.1985), *overruled on other grounds by Guiliano v. Cleo, Inc*., 995 S.W.2d 88 (Tenn.1999). The seller, or vendor, of the contract retains legal title as security, *see Cleveland v. Martin*, 39 Tenn. (2 Head) 128, 130-31 (1858), while the purchaser, or vendee, obtains an equitable ownership interest in the property. *King v. Dunlap*, 945 S.W.2d 736, 740 (Tenn.Ct.App.1996).

In re Carson, 286 B.R. 645, 649 (Bankr.E.D.Tenn., 2002). Clearly, McGuire acquired an equitable ownership interest in the property when he entered into the contract with Ables. Upon the conclusion of the fifteen-year term and payment of $100.00, McGuire would have acquired legal title to the property.

At the trial in this matter, McGuire asserted that he still had an equitable interest in the property at the time of filing his bankruptcy petition because Ables had not complied with the Tennessee requirements for non-judicial foreclosure sales. What McGuire overlooks in making this argument though is that the agreement he voluntarily entered into with Ables provided the terms in the event of a breach. The agreement clearly stated that if McGuire breached the agreement, Ables could send a notice of forfeiture setting forth the exact nature of the breach. McGuire then had ten days to comply with the notice and cure the breach. If he did not, the agreement provided that forfeiture would be declared. As Judge Brown recognized in the case of *In re Memphis-Friday's Associates*, 88 B.R. 830 (Bankr. W.D. Tenn. 1988), "in the absence of fraud or mistake, a contract must be interpreted and enforced as written even though it contains terms which may be thought harsh and unjust." *Id.* at 834 (citing *St. Paul Surplus Lines Ins. Co. v. Bishops Gates Ins. Co.*, 725 S.W.2d 948, 951 (Tenn. Ct. App. 1986)); T.C.A. § 47-50-112(a).

Ables sent notice to the McGuires on November 23, 2004, that by virtue of the default in payments as well as the cancellation of the insurance policy, they were in breach of the agreement. Ables gave them ten days to pay the outstanding rent and to reimburse him for the insurance policy he obtained after theirs was cancelled. If they did not cure the defaults, Ables would declare the agreement forfeited. The McGuires did not comply with the terms of the letter and, as such, the agreement was forfeited on December 3, 2004.

As a result of this forfeiture on December 3, 2004, McGuire did not have either an legal or equitable interest in the Newbern property at the time he filed his bankruptcy petition on January 31, 2005 and the

Newbern property did not become property of the estate. The automatic stay does not protect this property and Ables may proceed to enforce his state rights with regard to possession of the house.

III. ORDER

It is therefore **ORDERED** that the debtor's complaint to determine validity and extent of interest in property of the estate is **GRANTED AS FOLLOWS:**

The debtor did not have either a legal or equitable interest in the property located at 955 Dr. Hall Rd. in Newbern, TN, at the time the case was filed and, therefore, the property is not property of the estate. The debtor had no interest in the property at the time of filing the complaint.

Mailing Information

Timothy Latimer, Attorney for Debtor
J. Michael Gauldin, Attorney for Ables Investments, Inc.
Timothy Ivy, Chapter 13 Trustee