IN THE COURT OF APPEALS OF IOWA

No. 0-513 / 09-1843
Filed October 6, 2010

FRONTIER LEASING CORPORATION,
Plaintiff-Appellee,
vs.

JAMES S. KRUEGER, Individually,
LINDA L. KRUEGER, Individually,
EASTOWN AMOCO, INC.,
EASTTOWN STANDARD, INC.,
MUSSER ACCOUNTING FIRM, P.C.,
and PARTIES IN POSSESSION,
Defendants-Appellants.

Appeal from the Iowa District Court for Polk County, D.J. Stovall, Judge.

Appellants appeal from the district court's ruling dismissing all of their counterclaims and affirmative defenses on the basis of the hell or high water clause applicable to agreements that were secured by Frontier Leasing Corp.'s mortgage against James Krueger's real property. **AFFIRMED IN PART, REVERSED IN PART, AND REMANDED.**

Billy J. Mallory and Allison M. Steuterman of Brick Gentry P.C., West Des Moines, for appellants.

Aaron H. Ginkens and Edward N. McConnell of Ginkens & McConnell, P.L.C., Clive, for appellee.

Considered by Sackett, C.J., and Potterfield and Tabor, JJ.

POTTERFIELD, J.

I. Background Facts and Proceedings

At all times material to this case, James Krueger was the owner of real property located on Euclid Avenue in Des Moines. Krueger was the president of Easttown Standard, Inc., a gas station located at that location. Krueger obtained a loan through East Des Moines National Bank, which was secured by a mortgage on this property. At some point, Community State Bank bought East Des Moines National Bank. Krueger's loan payments remained the same, but Community State Bank did not pay the property taxes out of the mortgage payments. When Krueger became aware that Community State Bank had not been paying his property taxes, he contacted Ron Angell to inquire whether Angell would help him refinance his property to acquire cash to pay his property taxes and to use as operating capital. Angell was an employee of Frontier Leasing Corp.[1] with whom Krueger had developed a business relationship in past years through the completion of several business transactions. Angell agreed to help Krueger.

On January 17, 2003, Krueger completed a credit application for Frontier on behalf of Easttown. Krueger testified that roughly a week before the transaction was completed, Angell called him and stated that they "needed to list some equipment on there" since Frontier was in the leasing business. Accordingly, on March 19, 2003, Krueger faxed Angell a list of some equipment he owned along with approximate values for each piece of equipment.

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[1] Frontier is an Iowa corporation that engages in the leasing of equipment for commercial business purposes.

On March 27, 2003, Krueger signed a bill of sale showing that Easttown had sold to Frontier certain equipment on Krueger's list valued at $20,000. Krueger also signed "equipment lease agreement" number 41811 on behalf of Easttown. The document stated that it was a finance lease, contained a hell or high water provision, and provided for eighty-four monthly payments of $1565 each along with an advance payment at signing of $2065. A cover letter sent to Krueger with the agreement informed him that at the end of the payments, Krueger could repurchase the equipment from Frontier for one dollar. None of the documentation listed an interest rate, but Frontier's internal documents and Angell's testimony calculated the internal yield or time value of money for this agreement to be 11.83%.

Krueger signed a personal guaranty for agreement 41811 and a collateral agreement. The collateral agreement incorporated agreement 41811 "involving total equipment costs of approximately $90,000" and required Krueger to provide a mortgage on the real property located on Euclid Avenue as collateral for the payments due under agreement 41811. Thus, Krueger executed a mortgage in favor of Frontier on the Euclid Avenue property as security for performance under agreement 41811.

Angell and Krueger agreed that Frontier would provide Krueger $90,000, which was disbursed as follows: (1) Frontier wrote a check for $20,160.57 to Community State Bank to pay off Krueger's loan that was secured by the property on Euclid Avenue; (2) Frontier wrote a check for $28,939.38 to the Polk County Treasurer to pay Krueger's past due property taxes; (3) $1200 was paid in sales tax based on the sale of $20,000 worth of equipment; (4) $437 was used

for attorney fees for the mortgage work; and (5) $39,263.05 was paid to Easttown—$20,000 for the value of the equipment and the remainder for operating capital.

Angell testified that this transaction was a sale-leaseback, an arrangement in which one party sells an asset for cash and then leases it back long-term, retaining use of the asset, but losing ownership. Krueger testified that although he was given an opportunity to read the paperwork involved in this transaction, he did not understand the transaction to be a sale-leaseback. He did not understand that he was transferring title on the equipment. Rather, he believed Frontier considered the equipment to be collateral on a loan.

In August of 2005, Krueger entered into a second agreement with Frontier. This second transaction, agreement 41811-01, was another sale-leaseback whereby Easttown executed a bill of sale for an Allison transmission, which it leased back to Krueger. In exchange, Krueger received $23,000, of which $2000 was immediately paid to Frontier as an "amendment fee."[2] The second transaction required Krueger to make fifty-four payments of $100 and a final payment of $32,646. Further, the agreement provided that at the conclusion of the payments, Easttown would make three interest-only monthly payments of $530. Thus, agreement 41811-01 extended agreement 41811 by three months and was considered by Frontier to be an amendment to the original agreement. None of the documents executed in conjunction with agreement 41811-01 contained an interest rate, but Frontier's internal documents and Angell's

[2] Krueger testified that he knew nothing of the amendment fee and believed the lease amount was $21,000.

testimony calculated the internal yield or time value of money for this agreement to be 12.05%.

On April 12, 2006, in an unrelated transaction, Krueger executed a promissory note in favor of Musser Accounting Firm, P.C. in the amount of $99,168.65 for money owed for services rendered by Musser for Easttown. To further secure the promissory note, Krueger executed a mortgage on the Euclid Avenue property in favor of Musser on May 5, 2006. Musser testified that he assumed someone had a mortgage on the property superior to his mortgage. Musser had not petitioned for foreclosure on his mortgage at the time of trial.

In December 2007, Frontier notified Krueger that he was delinquent on payments due under the agreements. On September 12, 2008, Frontier filed a foreclosure petition against Krueger, Easttown, and Musser[3] based on the mortgage taken to secure agreement 41811. On March 10, 2009, Frontier filed an amended foreclosure petition for the amount of $88,802.68 plus interest, costs, and attorney fees. Frontier's foreclosure petitions allege the 2003 mortgage secured both the 2003 (41811) and the 2005 (41811-01) agreements.

Krueger's affirmative defenses included fraud in the inducement, estoppel, mutual mistake, unconscionability, and failure to disclose the interest rate in the written agreements. Krueger also counterclaimed, arguing: (1) the agreements at issue were loans, not leases; (2) the interest rates charged by Frontier were usurious and in violation of Iowa Code chapter 535 (2007); and (3) the affirmative

[3] State of Iowa, Polk County Treasurer, and City of Des Moines later were added as defendants, but do not participate in the appeal. We refer to all of the defendants-appellants—James and Linda Krueger, Easttown, and Musser—as "Krueger" for ease of identification.

defenses and counterclaims rendered the agreements void and unenforceable, necessitating rescission and restitution.

The court denied Frontier's motion for summary judgment on May 28, 2009, finding there were issues of material fact that necessitated a trial. After a one-day trial, on November 9, 2009, the district court ruled in favor of Frontier and dismissed Krueger's counterclaims. The district court found: (1) the two agreements at issue were finance leases; (2) the note on which the mortgage was based represented a valid debt; and (3) the hell or high water provision applicable to the agreements precluded any defenses and/or counterclaims in this case. Therefore, the district court ruled Frontier was entitled to foreclosure against Krueger's real property.

Krueger appeals, arguing: (1) the mortgage was not enforceable because it did not secure a valid debt; (2) the district court erred in finding the agreements were leases rather than secured transactions; and (3) the district court erred in finding the hell or high water clause was enforceable and precluded his affirmative defenses and counterclaims.

II. Standard of Review

The parties disagree on the standard of review for Frontier's mortgage foreclosure petition. Frontier filed its petition in equity. Mortgage foreclosure proceedings are generally heard in equity. *See W. Des Moines State Bank v. Pameco, Inc.*, 501 N.W.2d 555, 557 (Iowa Ct. App 1993). Krueger makes no citation to the record to support his contention that this is an action at law. Therefore, we will review Frontier's claim de novo. *See id.*

III. Finance Lease or Loan

Krueger argues on appeal that agreements 41811 and 41811-01 are not finance leases but rather loans. The district court found, "A thorough examination of all the exhibits does not reveal any indication that the agreements in questions were loans." All parties agree that the paperwork refers to the agreements as leases. Krueger argues, however, that simply titling the agreements as leases, or even affirmatively agreeing the documents were leases, does not necessarily make them leases. Frontier argues that the parties' mutual assent to the unambiguous language stating the agreements were leases demonstrates their intent that the transaction be a finance lease.

Iowa Code section 554.13103(1)(j) defines "lease" as a "means of transfer of the right to possession and use of goods for a term in return for consideration, but a sale . . . or retention or creation of a security interest is not a lease." Because a lease by definition does not include the creation of a security interest, we turn to the definition of security interest.

Iowa Code section 554.1201(37)(b) provides,

> 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
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> . . . .
>
> (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.

This statute "sets out a bright-line test, sometimes referred to as a per se rule, for determining whether a transaction creates a security interest as a matter of law."

In re Pillowtex, Inc. 349 F.3d 711, 717 (3d Cir. 2003). Courts interpreting this statute "have found it to mandate a finding of a security interest" if both of the elements listed above are satisfied. *C & J Vantage Leasing Co. v. Outlook Farm Golf Club, LLC*, 784 N.W.2d 753, 757 (Iowa 2010).

In the present case, the agreements contained an option to purchase the equipment at the end of the lease term for one dollar. This court found a similar arrangement to be a security interest rather than a lease in *Corporate Center Associates v. Total Group Services of Iowa, Inc.*, 462 N.W.2d 713, 715 (Iowa Ct. App. 1990). The *Corporate Center* case involved a "payment plan" agreement under which "lessee" made payments on furniture for a period of sixty months, at which time it had the option to purchase the furniture for one dollar. *Corporate Ctr. Assocs.*, 462 N.W.2d at 714. In *Corporate Center*, we stated, "It is clear . . . that when a lease agreement provides an opportunity to purchase the leased items for a nominal value, the agreement will be viewed as a security agreement." *Id.*; a*ccord C&J Leasing II Ltd. P'ship v. Swanson*, 439 N.W.2d 210, 211 (Iowa 1989) (finding an agreement with an option to purchase leased equipment for one dollar at the end of the lease term created a security interest). Because the one dollar repurchase price in this case is of a nominal nature, we find that the agreements are security agreements, not leases.

In determining that agreements 41811 and 41811-01 are security agreements, we recognize that all paperwork prepared in conjunction with both agreements referred to them as leases. Frontier argues, and the district court found, that under the freedom to contract doctrine, parties may (and in this case did) agree that a transaction is a lease, and their agreement will be binding.

However, the freedom to contract is not absolute. *See State v. Hutchinson Ice Cream Co.*, 168 Iowa 1, 21, 147 N.W. 195, 203 (1914). Parties cannot contract out of the clear provisions of the Iowa Code that define leases and secured transactions. We have examined the facts of this case pursuant to Iowa Code section 554.1201(37)(b) and determine that, in spite of Frontier's attempt to disguise this transaction as a lease, the sale-leaseback was actually a secured transaction.[4] Thus, this transaction is governed by article 9 of the Uniform Commercial Code (UCC) codified at Iowa Code section 554.9101 et seq.

IV. Enforceability of Frontier's Mortgage

Krueger also argues that Frontier's mortgage was not enforceable because it did not secure a valid debt. Krueger bases this argument on the language of the mortgage and the absence of an amount stated in the note. One provision in the mortgage document provides: "[T]he Obligations secured by this Mortgage shall not exceed in the aggregate three times the original principal sum of the Note." Krueger asserts that "Note" in this provision refers to an earlier provision that states:

> This mortgage secures Mortgagor's payment of the following (collectively the "Obligations"):
> (a) all indebtedness evidenced by the Note (the "Note") made by the Mortgagor . . . payable to the order of Mortgagee in the original principal sum of $0.00 . . . ;

[4] This is an approach other jurisdictions have taken when confronted with the same issue. *See, e.g.*, *SAL Leasing Inc. v. State*, 10 P.3d 1221, 1227-28 (Ariz. Ct. App. 2000) (holding that sale and leaseback of vehicles were disguised loans); *B&S Mktg. Enters., LLC v. Consumer Prot. Div.*, 835 A.2d 215, 234 (Md. Ct. Spec. App. 2003) (holding lower court did not err in looking beneath the forms to the substance of the transactions to determine that sale-leaseback transactions were actually loans); *Halco Fin. Servs., Inc. v. Foster*, 770 S.W.2d 554, 556 (Tenn. Ct. App. 1989) (looking to the substance of a sale and leaseback transaction to hold it was really a usurious loan).

> (b) all rental payments due under any lease agreement or agreements between Mortgagor as lessee and Mortgagee as lessor (collectively "Leases") of equipment . . . now or hereafter located or existing upon the Property . . . with total payments of $131,460.00.

Krueger asserts that because the mortgage states that the obligations it secures shall not exceed three times the principal sum of the Note, which is defined to be $0.00, the mortgage does not secure an existing indebtedness, citing *Greene v. Bride & Son Construction Co.*, 252 Iowa 220, 224, 106 N.W.2d 603, 606 (1960), for the proposition that in order to establish a valid mortgage, there must be existing indebtedness. Krueger argues in the alternative that because Frontier's mortgage is only secured for up to three times $0.00, Frontier's mortgage is inferior to Musser's mortgage.

Our goal in interpreting contracts is to ascertain the meaning and intention of the parties. *Petty v. Faith Bible Christian Outreach Ctr., Inc*., 584 N.W.2d 303, 305 (Iowa 1998). "Unless the contract is ambiguous, the court determines the parties' intent from the language of the contract. Consequently, where the intent of the parties is expressed in clear and unambiguous language, we enforce the contract as written." *Id.* (internal citation removed).

The note amount in this case is $0.00 because Frontier's paperwork provided that there was no note in this transaction.[5] However, the mortgage referenced the payments due under the first agreement as payments secured by the mortgage. We agree with the district court that the mortgage document clearly shows the parties intended it to secure payments due under the first

[5] Our analysis in this section refers to the agreements as they are described in the relevant paperwork. This section does not negate our finding above that the agreements were actually secured transactions, not leases.

agreement.[6] Thus, we agree with the district court that the mortgage secured a valid debt that was senior to the indebtedness of Musser and that Frontier was entitled to foreclose on its mortgage.

V. Hell or High Water Clause

The district court found that the agreements, whether they were characterized as leases or secured transactions, were subject to a valid and enforceable hell or high water provision that operated to cut off Krueger's defenses and counterclaims. Krueger argues: (1) because the agreements were loans, not leases, the provisions of the UCC enforcing the hell or high water clause are inapplicable; (2) the affirmative defenses survive a hell or high water clause; and (3) the agreements are illegal/unconscionable, rendering the hell or high water clause unenforceable.

We have discussed and agree with Krueger that the agreements are secured transactions and not finance leases or sale-leaseback agreements. We turn to the affirmative defenses and counterclaims raised by Krueger in the district court, which were dismissed on the ground that those defenses were cut off by the enforceable hell or high water clause applicable to the two agreements. The counterclaims and affirmative defenses at issue on appeal are: violation of Iowa Code chapter 535 regarding the failure to disclose the interest rate; unconscionability; fraudulent misrepresentation; equitable estoppel; and restitution/rescission.

[6] Krueger does not appear to dispute that the mortgage also secures the payments due under the second agreement (41811-01).

Defenses to contract formation may be raised despite an enforceable hell or high water clause. *See Outlook*, 784 N.W.2d at 758. Similarly, the hell or high water clause does not defeat Krueger's affirmative defense of unconscionability because this defense relates to the validity of the agreement itself. *See GreatAmerica Leasing Corp. v. Star Photo Lab, Inc.*, 672 N.W.2d 502, 505 (Iowa Ct. App. 2003) ("'It follows that contractual limitations upon remedies are generally to be enforced unless unconscionable.'" (quoting *In re O.P.M Leasing Servs. Inc.*, 21 B.R. 993, 1006-07 (Bankr. S.D.N.Y. 1982)).

We remand for the district court to rule upon those of Krueger's claims and defenses that implicate contract formation or unconscionability in light of our determination that these defenses survive the hell or high water clause applicable to the parties' security agreements.

AFFIRMED IN PART, **REVERSED IN PART, AND REMANDED.**