Case No. 14-3086

IN THE UNITED STATES COURT OF APPEALS
FOR THE TENTH CIRCUIT

IN RE ALTERNATE FUELS, INC.,
Debtor.

CHRISTOPHER JOHN REDMOND,
Appellee,

vs.

WILLIAM KARL JENKINS and M. EARLENE JENKINS,
Appellants.

Appeal from the U.S. Bankruptcy Appellate Panel for the Tenth Circuit
Hon. R. Kimball Mosier, U.S. Bankruptcy Judge; Case No. 12-110
United States Bankruptcy Court for the District of Kansas
Hon. Dale L. Somers, U.S. Bankruptcy Judge; Adversary Action No. 11-06026

BRIEF OF THE APPELLANTS

JONATHAN STERNBERG, Kan. #25902
Jonathan Sternberg, Attorney, P.C.
911 Main Street, Suite 2300
Kansas City, Missouri 64108
Telephone: (816) 292-7000
Facsimile: (816) 292-7050
E-mail: jonathan@sternberg-law.com

COUNSEL FOR APPELLANTS

ORAL ARGUMENT REQUESTED

Table of Contents

Table of Authorities

Cases

United States Bankruptcy Code (Title 11, United States Code)

Other United States Code Sections

<u>Statement of Related Cases</u>

There are no prior or related appeals.

Jurisdictional Statement

This is an appeal from a final judgment of the United States Bankruptcy Appellate Panel for the Tenth Circuit ("BAP"), which affirmed a final judgment of the United States Bankruptcy Court for the District of Kansas granting Appellee Christopher Redmond ("Trustee") partial relief on his adversary complaint against Appellants William Karl Jenkins and M. Earlene Jenkins ("the Jenkinses").

The bankruptcy court had jurisdiction under 28 U.S.C. §§ 157(a) and (b) and 1334(a) and (b) (Appellants' Appendix 31, 90, 233). It entered its final judgment on December 10, 2012 (Aplt.Appx.190). The Jenkinses filed their notice of appeal to the BAP on December 26, 2012 (Aplt.Appx.237). Under Fed. R. Bankr. P. 8002(a), the notice of appeal was timely, as it was filed within fourteen days of the judgment (Aplt.Appx.247). Therefore, the BAP had jurisdiction under 28 U.S.C. § 158(a)(1).

The BAP entered its final judgment on March 18, 2014 (Aplt.Appx.267). The Jenkinses filed their notice of appeal to this Court on April 17, 2014 (Aplt.Appx.269). Under Fed. R. App. P. 4(a)(1)(A) and 6(b), the notice of appeal was timely, as it was filed within thirty days of the BAP's final judgment. Therefore, this Court has appellate jurisdiction under 28 U.S.C. § 158(d).

Statement of the Issues

I. The bankruptcy court erred in disallowing and recharacterizing as equity the Jenkinses' $3,823,862.92 debt claim in AFI's bankruptcy for payment of three promissory notes, plus interest, because they proved the validity and amount of their claim and neither the law nor the evidence supported recharacterization. The undisputed promissory notes expressly treated the funds as loans and were valid, enforceable, and collectible by the Jenkinses under the law of Kansas, the Jenkinses acquired no management control of AFI in exchange for their loaned funds, and the parties intended the transactions to be loans.

II. The bankruptcy court erred in equitably subordinating the Jenkinses' $3 million secured claim to the status of an unsecured claim, because the Jenkinses have an allowed claim and, as a matter of law, have not engaged in inequitable conduct. The Jenkinses' transfers to AFI were not substitutions for equity or risk capital and their claim, intended to be secured, would not cause injury to other creditors of AFI, none of whom hold secured claims.

Statement of the Case

A. Background to AFI and Its 1992 Bankruptcy

AFI is a Kansas corporation that primarily was engaged in surface coal mining operations (Aplt.Appx.91). In December 1992, it filed a petition in bankruptcy in the United States Bankruptcy Court for the District of Kansas under Chapter 11 of the Bankruptcy Code ("the Code") (Aplt.Appx.855).

At the time of the 1992 bankruptcy, AFI was winding up its Kansas coal mining operations and transitioning to mining operations on three leased sites in Barton and Vernon Counties, Missouri, known as the "Blue Mound Mine" (Aplt.Appx.91). AFI held certain permits which allowed it to mine the Blue Mound Mine, which required that various bonds be submitted as surety for the eventual reclamation of the Blue Mound Mine site properties (Aplt.Appx.91). The bonds were secured by certificates of deposit AFI owned and subject to assignments to the State of Missouri, to be released as security upon completion of the Blue Mound Mine reclamation (Aplt.Appx.92).

In May 1993, the bankruptcy court appointed Kevin Checkett as Trustee (Aplt.Appx.868). Under the terms of AFI's confirmed plan, he was given authority to operate AFI's business under the terms of the plan (Aplt.Appx.1249-50,1074). Larry Pommier, who previously had worked for AFI, was rehired initially as AFI's field engineer and financial cost analyst (Aplt.Appx.91,618).

The 1992 bankruptcy was closed in September 1995 (Aplt.Appx.881). In 1996, Mr. Checkett ceased AFI's operations, abandoned its assets to its various secured creditors, and resigned as its trustee (Aplt.Appx.92). AFI remained liable for any debts not addressed in the 1992 bankruptcy (Aplt.Appx.195).

Ultimately, John Warmack acquired all of AFI's stock (Aplt.Appx.92). He provided AFI with certain new reclamation bonds and replacement reclamation bonds (Aplt.Appx.92). He took over the operations and control of AFI and appointed Mr. Pommier as AFI's President (Aplt.Appx.92,622-23).

Around the time of the 1992 bankruptcy, Mr. Warmack also formed Cimarron Energy Company, LLC ("Cimarron") (Aplt.Appx.137,195). He owned 99% of Cimarron's stock, and Mr. Pommier owned one percent (Aplt.Appx.137,195). AFI's equipment was released to its secured creditors, who ultimately foreclosed on the equipment and sold it to Cimarron (Aplt.Appx.92).

By December 1996, AFI's Corporate Annual Report filed with the Kansas Secretary of State listed Mr. Pommier as president and Mr. Warmack as sole director (Aplt.Appx.92,1080). The same was true in AFI's December 1999 and February 2000 reports (Aplt.Appx.92,1082).

As a result of the interrelationship of AFI and Cimarron, Cimarron became the operator of the mining operations for which AFI held permits on the Blue Mound Mine sites, even though the permits were in AFI's name (Aplt.Appx.92).

B. The Jenkinses' Involvement in AFI

The Jenkinses are husband and wife residents of Missouri (Aplt.Appx.92). They registered "Green Acres Farms" as a fictitious name with the Missouri Secretary of State (Aplt.Appx.91).

On December 6, 1999, the Jenkinses entered into an agreement to purchase from Mr. Warmack all of Mr. Warmack's shares of common stock in AFI, consisting of 530 shares, which was 100% of AFI's stock, along with equipment Cimarron owned (Aplt.Appx.92,1101-11). Mr. Jenkins testified the deal was Mr. Pommier's idea, who brought it to Mr. Jenkins with the promise that they "would make a lot of money" (Aplt.Appx.463,517).

The agreement was titled "Agreement for Sale of Interests Related to Blue Mound Mine Located in Bates and Vernon Counties" (Aplt.Appx.1101-11). The Jenkinses paid Mr. Warmack a check for $549,250.00, and Mr. Warmack executed a bill of sale to the Jenkinses (Aplt.Appx.1101-11,1231-32). The agreement provided that Mr. Warmack was to use the money to pay off AFI's secured debts on various pieces of equipment (Aplt.Appx.92).

The transfer to the Jenkinses also included all of Mr. Warmack's ownership of Cimmaron, which was 99% of Cimarron's stock, as well as all the certificates of deposit Mr. Warmack had pledged to the State of Missouri to guarantee reclamation of the Blue Mound Mine (Aplt.Appx.1101-11). The certificates of deposit and bonds amounted to approximately $1.3 million (Aplt.Appx.93,1101-11). AFI, Cimarron, and Mr. Warmack assigned the certificates and bonds directly to the Jenkinses (Aplt.Appx.1233-1319).

Mr. Pommier testified that, at the time Mr. Jenkins entered into the agreement with Mr. Warmack, Mr. Jenkins was listed on the Federal Office of Surface Mining's "Applicant Violator System," or "AVS" (Aplt.Appx.644-45). Dennis Meier of Triad Environmental Services testified the AVS was the Government's "way to penalize … habitual offenders" of mining site reclamation requirements "that were forfeiting bonds … as an economic savings" and forcing states to perform reclamations (Aplt.Appx.311-12).

Mr. Pommier said that, as a result, Mr. Jenkins could not "be an owner, operator of a service [*sic*] coal mining operation in the United States" (Aplt.Appx.644). He said that, because Mr. Jenkins was on the AVS list, Mr. Jenkins "could not own the stock in a company that was going to continue to operate" (Aplt.Appx.644). Mr. Pommier noted, however, that "since [Mr. Jenkins] didn't intend to operate [AFI] but only complete the reclamation," "that didn't really affect him" (Aplt.Appx.645). Still, Mr. Pommier said "there was a chance that it might and I informed [Mr. Jenkins] of that" (Aplt.Appx.645).

To avoid this chance, Mr. Pommier said he "advised [Mr. Jenkins] not to take the stock [of AFI] in his name and he came up with what he termed was a straw, which was Michael Christie, who would just hold the stock certificate" (Aplt.Appx.92,645). Mr. Christie was Mr. Jenkins's long time business associate and was on the AVS list (Aplt.Appx.92). On December 6, 1999, the Jenkinses and Mr. Christie entered into an "Option to Purchase" under which the Jenkinses sold Mr. Christie the right to purchase the AFI stock, thereby allowing the Jenkinses to retain their position as AFI's bondholder (Aplt.Appx.92-93).

By the time of the December 1999 agreements, mining operations at the Blue Mound Mine had ceased, but AFI remained responsible for the land reclamation, which was all that remained to be done (Aplt.Appx.93,628). AFI, Cimarron, and the Jenkinses sought to complete the reclamation so as to allow the Jenkinses to take possession of the certificates of deposit (Aplt.Appx.93). Immediately upon purchasing AFI, Cimarron, and the certificates of deposit, the Jenkinses loaned more money to AFI to complete the reclamation of the Blue Mound Mine (Aplt.Appx.470). As the bankruptcy court later put it, "AFI had no assets, no ongoing business, and the funds to operate the business were supplied by the Jenkinses" (Aplt.Appx.191).

In return for this money, on December 6, 1999, AFI executed a promissory note to the Jenkinses, signed by Mr. Pommier and Mr. Jenkins, for $500,000.00 (Aplt.Appx.470,1090). Titled, "Promissory Note," it provided that AFI, through Mr. Pommier, promised to pay to "Green Acres Farms" or its assigns $500,000.00

"together with interest thereon at the rate of 9.5% per annum on the unpaid balance" (Aplt.Appx.1090). It provided the "[p]rincipal balance plus accrued interest shall be due and payable five (5) years from" its signed date, and "[t]his note shall be paid in full upon reclamation bond release from the State of Missouri," noting that "[s]aid bonds currently being used to secure reclamation liability for Alternate Fuels, Inc at the Blue Mound Mine" (Aplt.Appx.1090). It described AFI as a "borrower" (Aplt.Appx.1090).

Although the Jenkinses owned 100% of AFI's stock and 99% of Cimarron's stock, they were merely investors in these companies; they left the day-to-day operation of AFI and Cimarron to Mr. Pommier, who was the sole employee of the companies (Aplt.Appx.473,694). Indeed, the parties stipulated that the Jenkinses "did not intend on operating AFI;" rather, "the sole purpose for Jenkins' [*sic*] investments in AFI were to obtain the proceeds of the equipment of AFI, Cimarron, and the Bonds/Certificates of Deposit following AFI's reclamation projects as required by the Permits" (Aplt.Appx.93-94). The bankruptcy court later agreed, finding that the Jenkinses "delegated the day-to-day operation of AFI and Cimarron to Pommier" (Aplt.Appx.197).

AFI had no income other than the money the Jenkinses loaned it; it paid all its expenses with money the Jenkinses loaned, including, unbeknownst to the Jenkinses, the $85,000 annual salary of Mr. Pommier, who was AFI's sole employee (Aplt.Appx.94,476). The Jenkinses continued to loan AFI money on other occasions (Aplt.Appx.818-46,1152-1230). In the year 2000 alone, the Jenkinses loaned AFI over $710,000 toward the reclamation (Aplt.Appx.1152).

Because of these continuing loans, AFI executed other promissory notes to the Jenkinses (Aplt.Appx.1096-97,1150). On November 6, 2000, AFI executed a promissory note to the Jenkinses, signed by Mr. Pommier and Mr. Jenkins, for $500,000.00 (Aplt.Appx.1150). Titled "Future Advances Promissory Note," it provided that AFI, through Mr. Pommier, promised to pay to "Green Acres Farms" or its assigns $500,000.00 "together with interest thereon at the rate of 9.0% per annum on the unpaid balance" (Aplt.Appx.1150). It provided the "[p]rincipal balance plus accrued interest shall be due and payable five (5) years from" its signed date, and "[t]his note shall be paid in full upon reclamation bond release from the State of Missouri," noting that "[s]aid bonds currently being used to secure reclamation liability for Alternate Fuels, Inc at the Blue Mound Mine" (Aplt.Appx.1150). It describes AFI as a "borrower" (Aplt.Appx.1150).

Then, on October 11, 2001, AFI executed a third promissory note to the Jenkinses, again signed by Mr. Pommier and Mr. Jenkins, but this time for $1 million (Aplt.Appx.1096). Titled "Promissory Note," it provided that AFI, through Mr. Pommier, promised to pay to "Green Acres Farms" or its assigns $1 million "together with interest thereon at the rate of 8.0% per annum on the unpaid balance" (Aplt.Appx.1096). As with the previous two notes, it provided the "[p]rincipal balance plus accrued interest shall be due and payable five (5) years from" its signed date, and "[t]his note shall be paid in full upon reclamation bond release from the State of Missouri," noting that "[s]aid bonds currently being used to secure reclamation liability for Alternate Fuels, Inc at the Blue Mound Mine" (Aplt.Appx.1096).

C. The *Cabanas* Lawsuit

All the evidence at trial was that, by 2002, reclamation of the Blue Mound Mine sites was nearly complete (Aplt.Appx.680-81,1233-1383). Mr. Pommier recounted that, in 2000, the State of Missouri estimated that the reclamation was nearly complete and would cost about $300,000 more to complete (Aplt.Appx.681). He testified that, in 2002, the reclamation was approximately 95-98% complete (Aplt.Appx.344). In 2002, R. Scott Brundage, a mined land reclamation consultant in Columbia, Missouri, prepared a detailed report for Mr. Pommier on the status of the reclamation, concluding that the reclamation was nearly complete (Aplt.Appx.1233-1383). Nonetheless, the State of Missouri would not certify that the reclamation was complete (Aplt.Appx.1113). AFI, Mr. Pommier, and the Jenkinses believed that the State was unreasonably blocking and interfering with their reclamation efforts (Aplt.Appx.574-75).

Accordingly, on December 23, 2002, AFI abandoned its reclamation efforts and AFI and Mr. Pommier filed suit in the United States District Court for the Western District of Missouri against Tom Cabanas and Richard Hall, officers and employees of the Missouri Department of Natural Resources, titled *Alternate Fuels, Inc. v. Cabanas* (Aplt.Appx.92,847). The complaint alleged claims for tortious interference with AFI's business, violation of 42 U.S.C. § 1983, and retaliation for the exercise of First Amendment rights (Aplt.Appx.847-53).

With the cessation of reclamation efforts pending the *Cabanas* lawsuit, the Jenkinses saw that their chances of recovering on AFI's certificates of deposit were diminishing (Aplt.Appx.480). As such, in exchange for continuing to fund AFI, and as security for their loans, the Jenkinses demanded an assignment of $3 million of any proceeds from the *Cabanas* lawsuit (Aplt.Appx.480). On March 1, 2003, while the *Cabanas* lawsuit was pending, Mr. Pommier agreed and executed on behalf of AFI an "Assignment of Chosen [*sic*] in Action," "unconditionally and irrevocably" assigning to the Jenkinses Three Million Dollars ($3,000,000.00) of their claims, demands and cause of action or causes of actions" in the *Cabanas* lawsuit (Aplt.Appx.1112).

The same day as the assignment of *chose* in action, March 1, 2003, Mr. Pommier executed a new promissory note to the Jenkinses in the amount of $2,370,761.00, stating it was renewing the three previous notes from December

1999, November 2000, and October 2001 (Aplt.Appx.1151). In the note, AFI, again described as "Borrower," promised to pay that amount to the Jenkinses, "together with interest at the rate of 8% per annum on the unpaid balance (Aplt.Appx.1151). It stated it was "due and payable on or before five (5) years from" its date of execution and "shall be paid in full upon reclamation bond release from the State of Missouri or proceeds from the lawsuit filed in Federal Court case no. 02CV1182" (Aplt.Appx.1151).

On September 29, 2006, after a jury trial, AFI obtained a judgment in the *Cabanas* lawsuit for $5,563,778.00 in actual damages and $900,000.00 in punitive damages (Aplt.Appx.92,854). The Jenkinses filed a notice to all interested parties that the judgment was subject to their assignment (Aplt.Appx.1089). After the Eighth Circuit affirmed the judgment, *Alternate Fuels, Inc. v. Cabanas*, 538 F.3d 969 (8th Cir. 2008), on September 18, 2008, the State of Missouri paid $4,956,377.68 into the district court's registry, the full amount of the judgment after contingent attorney fees and costs (Aplt.Appx.93).

No payments ever were made to the Jenkinses on any of AFI's promissory notes (Aplt.Appx.94).

D. Proceedings Below

On January 28, 2009, AFI filed a petition in bankruptcy before the United States Bankruptcy Court for the District of Kansas under Chapter 11 of the Code

(Aplt.Appx.90). On June 12, 2009, the bankruptcy court appointed Christopher J. Redmond as Trustee (Aplt.Appx.90). The court ordered any proofs of interest filed by July 13, 2009 (Aplt.Appx.90). The claims register is included in Appellants' Appendix at pages 883-87. On June 30, 2009, the $4,956,377.68 from the *Cabanas* judgment was transferred to the Trustee (Aplt.Appx.93,199). Those proceeds "are the only asset of AFI that is available" to pay creditors (Aplt.Appx.222-23). In its bankruptcy schedule, AFI listed the Jenkinses as creditors (Aplt.Appx.94).

Among others, the following unsecured claims against AFI were timely filed: (1) $1,711,222.00 by construction companies involved in the reclamation (Aplt.Appx.888); (2) $1,036,348.52 by Traveler's Insurance as a surety on the reclamation (Aplt.Appx.953); (3) two separate claims for $1,048,421 by Continental Casualty & Insurance stemming from a 1993 indemnity agreement from AFI's first bankruptcy (Aplt.Appx.995); (4) three claims by the State of Missouri through the Missouri Department of Natural Resources totaling $1,175,000.00 for the alleged remaining cost of completing the reclamation (Aplt.Appx.969,971,973); and a claim by the State of Missouri through the Missouri Department of Natural Resources for $525,836.58 on its July 2009 judgment against AFI under the consent agreement (Aplt.Appx.975).

On July 11, 2009, the Jenkinses timely filed a proof of claim in the principal amount of $4,336,813.10, which they filed as a secured claim (Aplt.Appx.57,90). They attached to their proof of claim: (1) the March 2003 "Assignment of Chosen [*sic*] in Action" and subsequent September 2006 Notice of Assignment of Judgment; (2) the December 1999 Promissory Note for $500,000.00 and a calculation of interest on the note through October 2008 totaling $1,117,013.84; (3) the November 2000 Promissory Note for $500,000.00 and a calculation of interest on the note through October 2008 totaling $982,963.05; (4) the October 2001 Promissory Note for $1,000,000.00 and a calculation of interest on the note through October 2008 totaling $1,723,886.03; and (4) a list of the certificates of deposit assigned to the Jenkinses listed by bank, account number, and amount, totaling $1,377,000.00 (Aplt.Appx.59-70). They also attached a list of other "money" and "accounts" in their claim from their payment of expenses for the reclamation, totaling $512,950.18 (Aplt.Appx.71).

In their summary, the Jenkinses explained their claims arose from AFI's promissory notes to them and the certificates of deposit Mr. Warmack assigned to them (Aplt.Appx.58). At the same time, they objected to the State of Missouri's claims on AFI's bankruptcy estate, explaining that, in reality, *they* had undertaken the expense of reclamation (Aplt.Appx.58). By the time of the judgment below, the Trustee had undertaken completion of the reclamation (Aplt.Appx.325).

The total amount of claims in AFI's bankruptcy was $11,247,349.18 (Aplt.Appx.883-87). All the claims except for the Jenkinses' were unsecured (Aplt.Appx.883-87,199-200). The total amount of unsecured claims was $5,735,536.08 (Aplt.Appx.883-87,199-200).

On January 27, 2011, the Trustee filed a six-count adversary proceeding against the Jenkinses and Cimarron, primarily challenging the Jenkinses' right to payment of their claim (Aplt.Appx.13-14,29). In Count I, the Trustee sought recharacterization and disgorgement of the claim, arguing the Jenkinses' advances to AFI described in the promissory notes were infusions of equity, not loans (Aplt.Appx.43-45). Count II sought equitable subordination of any security interest and claim under § 510(c) of the Code (Aplt.Appx.45-49). Count III sought a declaratory judgment and restitution for the Trustee's costs of completing the reclamation enforced by a trust or lien on the certificates of deposit assigned to the Jenkinses (Aplt.Appx.49-53). Count IV sought the court to order the Jenkinses to provide an accounting for the profits, revenues, and expenses arising from AFI's mining permits (Aplt.Appx.53-54). Count V sought an accounting of the Jenkinses' claim (Aplt.Appx.56). Finally, Count VI generally objected to the Jenkinses' claim (Aplt.Appx.57).

The Jenkinses denied the Trustee's claims (Aplt.Appx.74-83). Cimarron defaulted, never filing any answer or response (Aplt.Appx.289).

After a pretrial order detailing the parties' extensive stipulations of which the bankruptcy court later took judicial notice (Aplt.Appx.88,126), the case was tried before the bankruptcy court over three days in August 2012 (Aplt.Appx.24-25,125-28,271,385,499). At trial, the Jenkinses introduced the March 2003 Promissory Note in the amount of $2,370.761 renewing the three previous notes plus interest and referencing the *Cabanas* lawsuit (Aplt.Appx.204,481,1151). The only witnesses at trial were Mr. Meier, Mr. Pommier (who testified via video deposition, the transcript of which was admitted into evidence and is in Appellants' Appendix at pages 611-817), the Trustee, Mr. Jenkins, and a records custodian (Aplt.Appx.126-28).

On December 10, 2012, the bankruptcy court entered its final memorandum, order, and judgment (Aptl.Appx.27,190,232). The court granted the Trustee relief on its Counts I, II, V, and VI (Aplt.Appx.230-31). It stated it "found neither [Mr. Jenkins nor Mr. Pommier] to be very credible," because Mr. "Pommier and W.K. Jenkins openly displayed hostility toward one another. W.K. Jenkins' testimony was permeated by a lack of recollection and was often not responsive to the questions posed. Further, the events about which the witnesses testified occurred approximately ten years prior to the trial" (Aplt.Appx.194). Therefore, the court stated it "relie[d] heavily upon the exhibits" (Aplt.Appx.194).

As to Count I, analyzing the 13-factor test in *In re Hedged-Invs. Assocs.*, 380 F.3d 1292 (10th Cir. 2004), the court held the Jenkinses' transfers to AFI in the promissory notes should be recharacterized as equity (Aplt.Appx.210-18). It found that the funds were transferred in express promissory notes bearing interest rates and for valid consideration, the use of the funds by AFI "to meet operating expenses" were "generally more indicative of a loan," "there is no evidence that W.K. Jenkins increased his participation in AFI as a result of his advancements," and there was no subordination of the Jenkinses' advances "to claims of other creditors" (Aplt.Appx.231-17). But it also found there was a lack of a "fixed maturity date," the release of the certificates of deposit was required to repay the notes, the Jenkinses did not attempt to enforce the notes after five years, the purpose of the notes was to secure the Jenkinses' investments in AFI, there was "thin capitalization of AFI," the Jenkinses owned 100% of AFI's stock, and AFI was unable to obtain funds from outside sources (Aplt.Appx.213-17).

The court held, "Application of the[se] factors" required it "to conclude that the advances represented by the three notes were equity infusions and not true loans" (Aplt.Appx.217). It also held the Jenkinses' transfer of $487,298.62 "for money related to reclamation and accounts" also "should be recharacterized as equity" (Aplt.Appx.218). Accordingly, because it held the entirety of the Jenkinses' debt claim was disallowed, and "only allowed claims may be secured claims," it held "the estate's interest in the proceeds of the Cabanas Lawsuit is not encumbered by a lien that secures any of the amount claimed by the Jenkinses" (Aplt.Appx.218-19).

As to Count II, the court held that, alternatively, even if the Jenkinses "hold an allowed secured claim, absent subordination, allowance of that claim would cause injury to other creditors of AFI" (Aplt.Appx.223). It found Mr. Jenkins "engaged in inequitable conduct when obtaining the Notes from AFI and taking the assignment of the judgment as security for his transfers to AFI," as he "in effect admitted to breaching his fiduciary duties" to AFI by "stating his purpose when operating AFI was to secure the release of Certificates of Deposit for his personal benefit" (Aplt.Appx.221). It also found inequitable that Mr. Jenkins, while "legally blocked from owning the stock of a surface coal mining company," nonetheless "arranged for ownership of [the Jenkinses'] interest in AFI to be held by a straw man," and "has not accounted for the sales of assets of AFI" (Aplt.Appx.221-22). Again, it found the "Jenkinses' 'loans' to AFI were in fact substitutions for equity or risk capital" (Aplt.Appx.222).

Because the Jenkinses' "transfers to AFI were beneficial to AFI and its bonding company creditors," as "[a]bsent the transfers, no reclamation could have been undertaken," however, the court declined the Trustee's request to subordinate the Jenkinses' claim underneath "all administrative expenses and all other unsecured claims" (Aplt.Appx.223). Instead, it held it was "equitable" to subordinate the claim "to the level of an unsecured claim on par with the other unsecured claims" (Aplt.Appx.223-24).

As to Count III, the bankruptcy court denied the Trustee's request for a declaratory judgment surcharging the Jenkinses' interest in the certificates of deposit as restitution (Aplt.Appx.224-27). It held that while, "at first impression … it may appear inequitable" that, upon reclamation, "the Jenkinses will be entitled to the proceeds of the Certificates of Deposit," this was not so (Aplt.Appx.225). Rather, "the obligation to complete the reclamation is AFI's not the Jenkinses," and the court "cannot conclude that the reclamation obligations would be personal liabilities of the Jenkinses" (Aplt.Appx.225-26).

The bankruptcy court also denied the Trustee's Count IV because "the Trustee fail[ed] to provide any legal or factual basis" "for an order requiring W.K. Jenkins to account … for all revenues, income, and proceeds received by Cimarron and AFI from 1999 through the date" AFI filed its 2009 bankruptcy action (Aplt.Appx.227).

As to Counts V and VI, decided together, the court held the "Jenkinses have not fulfilled" their "burden of persuasion as to the validity and amount of the[ir] claim" (Aplt.Appx.227-28). "Although the record is sufficient for the Court to conclude that some transfers were made by the Jenkinses to AFI, neither the attachments to the proof of claim nor the trial evidence is sufficient for the Court to determine the amount owed to the Jenkinses, if their transfers to AFI are not recharacterized as equity" (Aplt.Appx.228). The court granted relief on Counts V and VI, holding the "Jenkinses' claim is subject to denial on this basis alone" (Aplt.Appx.228).

The Jenkinses timely appealed to the Tenth Circuit BAP (Aplt.Appx.237,247). On March 18, 2014, the BAP issued a published opinion affirming the bankruptcy court's judgment (Aplt.Appx.239). The Jenkinses then timely appealed to this Court (Aplt.Appx.269).

Summary of the Argument

Until this case, no reported decision from any court within this Circuit *ever* ultimately had approved either (1) a recharacterization of a debt valid under state law in a bankruptcy as equity or (2) an equitable subordination of a secured claim in bankruptcy to the status of an unsecured claim. For the first time, however, the bankruptcy court in this case held the Jenkinses' promissory notes from AFI, which are valid debts under Kansas law, nonetheless should be recharacterized as equity and disallowed as a claim. Alternatively, and also for the first time, it held the portion of the Jenkinses' claim that was secured should be equitably subordinated to the status of an unsecured claim. Both holdings were error.

To determine that the Jenkinses' claim should be recharacterized, the bankruptcy court used a 13-factor test this Court adopted in 2004 from a 2001 decision of the Sixth Circuit, which, in turn, was adopted from a 1984 Eleventh Circuit decision. As the Fifth and Ninth Circuits more recently have held, however, that 13-factor test no longer is permissible under the Supreme Court's decision in *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443 (2007), which held the *only* criterion under § 502(b) of the Code as to whether a claim is allowed is whether it is valid under state law. If so, § 502(b) *requires* it be allowed. As a result, and as the Fifth and Ninth Circuits have observed, a debt only can be recharacterized as equity if the state law allows this.

Moreover, the Supreme Court recently emphasized in *Law v. Siegel*, 134 S.Ct. 1188 (2014), that a bankruptcy court's equitable powers under § 105(a) of the Code do not empower it to override other express Code provisions. Here, as the promissory notes were valid, enforceable, and collectible under Kansas law, which does not recognize the recharacterization of valid promissory notes as equity, the bankruptcy court lacked power to recharacterize them.

Even under the previous 13-factor test, though, the bankruptcy court still erred in recharacterizing the promissory note debts as notations of capital infusions. The notes expressly treated the funds as loans and had all the proper formalities of commercial loans, the Jenkinses had the right to enforce payment of principal and interest, they acquired no management control of AFI in exchange for their loaned funds, and the parties intended the transactions to be loans.

Equitable subordination also was error. It required the Trustee to prove both (1) "inequitable conduct" on the part of the claimant; (2) injury to the other creditors of the bankrupt or unfair advantage for the claimant resulting from the claimant's conduct. Neither requirement is present. As a matter of law, the Jenkinses did not engage in "inequitable conduct" within the meaning of the test, nor was there the required "injury to other creditors" or "unfair advantage."

This Court should reverse the bankruptcy court's judgment and require it to allow the Jenkinses' secured claim against AFI.

<u>Argument</u>

I. The bankruptcy court erred in disallowing and recharacterizing as equity the Jenkinses' $3,823,862.92 debt claim in AFI's bankruptcy for payment of three promissory notes, plus interest, because they proved the validity and amount of their claim and neither the law nor the evidence supported recharacterization. The undisputed promissory notes expressly treated the funds as loans and were valid, enforceable, and collectible by the Jenkinses under the law of Kansas, the Jenkinses acquired no management control of AFI in exchange for their loaned funds, and the parties intended the transactions to be loans.

Raised below and decided by the BAP (Aplt.Appx.249-63)

<u>Standard of Appellate Review</u>

"Although the [Jenkinses] appea[l] from the BAP's ruling, this court reviews the decision of the bankruptcy court." *In re C.W. Mining Co.*, 749 F.3d 895, 898 (10th Cir. 2014). This Court applies "the same standards of review that govern appellate review in other cases." *Id.* (citation omitted).

"Whether a transaction labeled as a loan should be recharacterized as an equity investment is a mixed question of fact and law." *In re Hedged-Invs. Assocs.*, 380 F.3d 1292, 1297 (10th Cir. 2004). While the Court "defer[s] to the bankruptcy court's findings regarding the fundamental facts of the transaction, reviewing them under a clearly erroneous standard," the "application of [the] legal test for recharacterization to those underlying facts … is a question of law … review[ed] *de novo*." *Id.* at 1297-98.

* * *

Recharacterization of a bankruptcy creditor's debt claim as equity does not lie when the debt would be enforceable under state law, the document memorializing it only evinces a commercial loan, and no management control was exchanged for the loaned funds. AFI's promissory notes to the Jenkinses were enforceable and collectible under Kansas law, only evince a commercial loan, and gave the Jenkinses no management control. Nonetheless, the bankruptcy court held they should be recharacterized as equity contributions to AFI. Was this error?

It is not in dispute that the Jenkinses hold three promissory notes from AFI, each of which was titled "promissory note," was in consideration for transferred funds, named AFI as the "borrower," bore an interest rate, provided terms of repayment, and were enforceable under Kansas law (Aplt.Appx.1090,1096-97,1150). Applying the Sixth Circuit's 13-factor test from *In re AutoStyle Plastics, Inc.*, 269 F.3d 726, 748-49 (6th Cir. 2001), however, which this Court adopted in *In re Hedged-Invs. Assocs.*, 380 F.3d 1292, 1298 (10th Cir. 2004), the bankruptcy court held "the advances represented by" AFI's three promissory notes to the Jenkinses "were equity infusions and not true loans" (Aplt.Appx.218).

This was error. First, the 13-factor *AutoStyle* test is improper and should be overruled. The Sixth Circuit adopted it in 2001 from one the Eleventh Circuit created in 1986 for tax cases. *AutoStyle*, 269 F.3d at 750 (citing *Stinnett's Pontiac Serv., Inc. v. Comm'r of Internal Revenue*, 730 F.2d 634, 638 (11th Cir. 1984)).

More recently, however, the Supreme Court in *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443 (2007), re-cemented that the only permissible test of whether a debt claim is allowable under § 502(b) of the Code is whether the debt would be enforceable as such under state law. If it is, § 502(b) expressly *requires* the bankruptcy court to allow it. And just this year, the Supreme Court held in *Law v. Siegel*, 134 S.Ct. 1188 (2014), that a bankruptcy court's equitable powers under § 105(a) of the Code do not permit it to override explicit mandates of other parts of the Code.

As the Fifth and Ninth Circuits have recognized post-*Travelers* in rejecting the 13-factor *AutoStyle* test, the 13-factor test is improper and should be overruled. Under the proper test, as the promissory notes here plainly were enforceable debts under Kansas law, recharacterization was error.

Even using the 13-factor test, however, *Hedged* points out that recharacterization was error here. Under *Hedged*, whether the Jenkinses were "insiders" of AFI was insufficient to support recharacterization. Rather, as the promissory notes have all the requisite form of a standard commercial loan, were enforceable, and gave the Jenkinses no added control over AFI, under *Hedged* recharacterization of the promissory note transfers as equity infusions was error.

This Court should reverse the bankruptcy court's judgment granting the Trustee relief on Count I of its complaint.

A. As the promissory notes were valid, enforceable, and collectible under Kansas law, § 502(b) required the bankruptcy court to allow the Jenkinses' claim.

1. *Travelers* and *Law* require this Court to overrule its previous 13-factor recharacterization test and agree instead with more recent decisions of the Fifth and Ninth Circuits that a claim must be allowed when it is a valid debt under state law.

"When a putative loan to a corporation is recharacterized, the courts effectively ignore the label attached to the transaction at issue …. The funds advanced are no longer considered a loan which must be repaid in bankruptcy proceedings as corporate debt, but are instead treated as a capital contribution." *Hedged*, 380 F.3d at 1297. This is different than "equitable subordination," in which the "funds in question are still considered outstanding corporate debt, but the courts seek to remedy some inequity or unfairness perpetrated against the bankrupt entity's other creditors or investors by postponing the subordinated creditor's right to repayment until others' claims have been satisfied." *Id.*

Thus, when an adversary claims both recharacterization and equitable subordination, the bankruptcy court must "first determine whether the transaction was a contribution to capital rather than a loan," and then, separately, "whether there was any fraud or sharp dealing requiring subordination …." *In re Mid-Town Produce Term., Inc.*, 599 F.2d 389, 393-94 (10th Cir. 1979).

In analyzing the first issue – recharacterization – the results of the Circuits that have dealt with it fall squarely into three categories. First, the Eleventh Circuit has adopted a broad, two-pronged test holding shareholder loans may be deemed capital contributions in one of two circumstances: (1) where the trustee proves initial undercapitalization; or (2) where the trustee proves that the loans were made when no other disinterested lender would have extended credit. *In re N & D Properties, Inc.*, 799 F.2d 726, 733 (11th Cir. 1986). Other courts have called this "amazingly broad" and "arguably draconian." *See In re Equip. Equity Holdings*, 491 B.R. 792, 848-49 (Bankr. N.D.Tex. 2013).

Second, in what is presently the plurality approach, the Third, Fourth, and Sixth Circuits, as well as this Court, have relied upon § 105(a) of the Code as authority to recharacterize a loan as equity and have adopted the 13-factor *AutoStyle* test or some other multi-factor form thereof. *See In re SubMicron Sys. Corp.*, 432 F.3d 448, 455 n. 8 (3d Cir. 2006); *In re Official Comm. of Unsecured Creditors for Dornier Aviation (N. Am.), Inc.*, 453 F.3d 225, 233-34 (4th Cir. 2006); *AutoStyle*, 269 F.3d at 747–53; *Hedged*, 380 F.3d at 1298.

In this Court, those factors are as follows:

(1) the names given to the certificates evidencing the indebtedness;
(2) the presence or absence of a fixed maturity date;
(3) the source of payments;
(4) the right to enforce payment of principal and interest;
(5) participation in management flowing as a result;
(6) the status of the contribution in relation to regular corporate creditors;
(7) the intent of the parties;
(8) "thin" or adequate capitalization;
(9) identity of interest between the creditor and stockholder;

> (10) source of interest payments;
> (11) the ability of the corporation to obtain loans from outside lending institutions;
> (12) the extent to which the advance was used to acquire capital assets; and
> (13) the failure of the debtor to repay on the due date or to seek a postponement.

Hedged, 380 F.3d at 1298 (quoting *AutoStyle*, 269 F.3d at 750 (quoting *Stinnett's*, 730 F.2d at 638))).

Both of those approaches, however, pre-date the Supreme Court's decision in *Travelers*, 549 U.S. at 450-51. There, the Court reiterated it has "long recognized that the 'basic federal rule' in bankruptcy is that state law governs the substance of claims, Congress having 'generally left the determination of property rights in the assets of a bankrupt's estate to state law.'" *Id.* (quoting *Butner v. United States*, 440 U.S. 48, 54, 57 (1979)). The Court restated its rule in *Butner* that "'[p]roperty interests are created and defined by state law,' and '[u]nless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.'" *Id.* at 451 (quoting *Butner*, 440 U.S. at 55).

In *Travelers*, the Ninth Circuit, relying on its own precedent, had held attorney fees were not recoverable in bankruptcy "for litigating issues peculiar to federal bankruptcy law." *Id.* at 451 (internal quotation omitted). In a unanimous reversal, the Supreme Court criticized the Ninth Circuit for relying "solely on a rule of that court's own creation." *Id.* Because the creditor's contractual right to attorney fees would be enforceable under California state law, the pre-petition contract could give rise to a "claim" in bankruptcy. *Id.* As such, the Ninth Circuit had erred in holding that a right to attorney fees for litigating bankruptcy issues never gives rise to a claim in bankruptcy. *Id.* at 450–52; *see also Raleigh v. Ill. Dept. of Revenue,* 530 U.S. 15, 21 (2000) (where there was "no sign that Congress meant to alter" a state substantive right, the *Butner* rule required a creditor's claim to be assessed in light of state law, including the allocation of the burden of proof).

Thus, *Travelers* held anew that, under the *Butner* rule, a court may not fashion a test "solely of its own creation" in determining what constitutes a "claim" for purposes of bankruptcy. Instead, "subject to any qualifying or contrary provisions of the Bankruptcy Code," a court must determine whether the asserted interest in the debtor's assets is a "right to payment" recognized under state law. *Raleigh,* 530 U.S. at 20. That is the *only* inquiry involved in whether, unless a provision of the Code says otherwise, a claim is allowable. *Id.* Thus, if the asserted interest is enforceable or collectible under state law, it is an allowed claim in bankruptcy. *Id.*

Unlike the "draconian" Eleventh Circuit approach and the plurality approach this Court joined in 2004, both of which predate *Travelers*, the third of the three approaches to recharacterization, shared by the Ninth and Fifth Circuits, was promulgated after *Travelers*. This approach echoes *Travelers* and holds the authority of bankruptcy courts to recharacterize debts is derived from the authority to allow or disallow claims under § 502(b) of the Code, rather than the court's general equitable powers under § 105(a). *In re Lothian Oil*, 650 F.3d 539, 542-44 (5th Cir. 2011).

Section 502(b) provides a bankruptcy court "*shall* allow such claim, except to the extent that … such claim is unenforceable … under any agreement or applicable law," (emphasis added), and "applicable law" within the meaning of § 502(b) means only *state* law. *Lothian*, 650 F.3d at 544 (quoting *Butner*, 440 U.S. at 54). Thus, under *Butner* and post-*Travelers*, the only permissible test of recharacterization is whether the alleged debt would be enforceable as such under the applicable state law. *Id.* The bankruptcy court must look to the state law to determine whether the claim may, or should, be recharacterized.

Ultimately, in *Lothian*, because the claim at issue was governed by Texas law, which recognizes recharacterization and utilizes a multi-factor analysis similar to the *AutoStyle* test, the Fifth Circuit applied that test. *Id.* (citing *Arch Petroleum, Inc. v. Sharp*, 958 S.W.2d 475, 477 n. 3 (Tex. App. 1997)). But this was only because that was what the applicable law – the law of Texas – called for. *Id.*

Thereafter, the Ninth Circuit adopted the same approach. *In re Fitness Holdings Int'l*, 714 F.3d 1141, 1146-49 (9th Cir. 2013). Previously, the Ninth

Circuit BAP had rejected the concept of recharacterization, holding bankruptcy courts lack the authority to recharacterize loans as capital contributions. *In re Pacific Express*, 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986).

In *Fitness*, the Ninth Circuit overruled *Pacific Express* and instead agreed with the Fifth Circuit in *Lothian*. 714 F.3d at 1146-49. Drawing broadly from *Travelers* and *Butner*, the Ninth Circuit held that, as *Travelers* made clear that a "claim" under the Code is "a right to payment recognized under state law," and federal courts may not rely "solely on a rule of [their] own creation" to thwart or disregard that applicable state law, in engaging in a recharacterization analysis the federal court only may "determine whether the asserted interest in the debtor's assets is a "right to payment" recognized under state law." *Id.* The authority to recharacterize flows from § 502(b), under which "'applicable' law is *state* law." *Id.* at 1148 (emphasis in the original).

Further, the Ninth Circuit expressly rejected the multi-factor *AutoStyle* approach, noting that the state-law test was "more consistent with" recent "Supreme Court precedent than that of the circuits that have fashioned a federal test for recharacterizing an alleged debt in reliance on their general equitable authority under 11 U.S.C. § 105(a)." *Id.* at 1148. This was because:

> Such an equitable approach is inconsistent with Supreme Court precedent requiring us to determine whether a party has a "right to payment," i.e., a "claim," § 101(5), by reference to state law. Given the Supreme Court's direction, courts may not rely on § 105(a) and

> federal common law rules "of [their] own creation" to determine whether recharacterization is warranted. [*C*]*f.* James M. Wilton & Stephen Moeller–Sally, *Debt Recharacterization Under State Law,* 62 BUS. LAW. 1257, 1278 (Aug. 2007) ("Federal courts, if they are to follow Supreme Court precedent, cannot create a separate legal standard for the enforceability of insider debt in bankruptcy and should follow the state law of debt recharacterization.").

Id. at 1148-49 (some internal citations omitted).

Accordingly, the only permissible test of whether a bankruptcy court may or should recharacterize a claimed debt obligation as equity is "whether th[e] obligation gives the holder of the obligation a 'right to payment' under state law." *Id.* at 1149.

That this is the only permissible approach further has been cemented by the Supreme Court's even more recent decision in *Law*, which rejected a broad reading of a bankruptcy court's equitable powers in § 105(a) and, instead, made those powers subordinate to the explicit mandates of other parts of the Code. 134 S.Ct. at 1194. Both the bankruptcy court and the BAP held in this case that § 105(a) gave it the power to recharacterize AFI's debts to the Jenkinses as equity, despite the mandatory language in § 502(b) that, where a claim is a valid debt under state law, it "*shall*" be allowed (Aplt.Appx.211,251).

In *Law*, however, the Supreme Court rejected exactly that broad reading, holding instead that, while § 105(a) gives a bankruptcy court "statutory authority to 'issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of' the Bankruptcy Code," "it is hornbook law that § 105(a) 'does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code.'" 134 S.Ct. at 1194 (quoting 2 COLLIER ON BANKRUPTCY ¶105.01[2], p. 105–6 (16th ed. 2013)). Thus, "Section 105(a) confers authority to 'carry out' the provisions of the Code, but it is quite impossible to do that by taking action that the Code prohibits. That is simply an application of the axiom that a statute's general permission to take actions of a certain type must yield to a specific prohibition found elsewhere." *Id.*

Accordingly, the Court held that when a bankruptcy court ordered an amount protected by a debtor's homestead exemption be equitably un-exempted and instead be made available to pay a trustee's attorney fees, "the court exceeded the limits of its authority under § 105(a)," because "§ 522 does not give courts discretion to grant or withhold exemptions based on whatever considerations they deem appropriate." *Id.* at 1195. "'[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of' the Bankruptcy Code." *Id.* at 1194 (citation omitted).

The same logically must be true as to how § 105(a) affects the explicit requirements of § 502(b). Section 502(b) mandates that bankruptcy courts "*shall* allow such claim" unless it "is unenforceable … under" state law. To paraphrase *Law*, § 502(b) "does not give courts discretion to grant or withhold [claims] based on whatever considerations they deem appropriate." 134 S.Ct. at 1196. Rather, whatever power a bankruptcy court may have under § 105(a) to recharacterize debts as equity "only may be exercised within the confines of" § 502(b), *id.* at 1194 – when *state law* allows such an action. Section 105(a) cannot provide a *separate* means to deem this state-law debt somehow *not* a debt.

Given *Travelers* and *Law*, making plain that the state-law test of the Fifth and Ninth Circuits is the only approach to recharacterization now legally permissible, this Court should overrule its older, multi-factor test plainly now rejected by the Supreme Court. The Court should follow *Travelers* and *Law* and analyze only whether AFI's promissory notes gave the Jenkinses a right to payment under Kansas law.

2. AFI's promissory notes to the Jenkinses are valid debts under Kansas law that give the Jenkinses a right to payment.

In this case, the parties stipulated that "the law governing this case is that of the State of Kansas" (Aplt.Appx.94). The promissory notes AFI executed to the Jenkinses plainly were enforceable and collectible under Kansas state law. Indeed, the bankruptcy court indicated as much, stating that the notes gave "the Jenkinses the right to enforce payment after five years," but because "AFI had no ability to pay" and thus "any attempt to enforce payment would be futile," "[n]o attempts were made to enforce the Notes" (Aplt.Appx.215-16).

The law of Kansas broadly enforces promissory notes. *See, e.g., Thornton Nat. Bank v. Robertson*, 132 P. 193, syll. (Kan. 1913); *Yancey v. Stork*, 201 P.3d 1, 2009 WL 398988 at *3 (Kan. App. 2009) (unpublished). As long as there is "sufficient consideration … in the hands of the payee," which "may be either a substantial equivalent in value received by the maker or a like equivalent parted with by the payee," a promissory note is valid and enforceable in Kansas. *Thornton*, 132 P. at syll., 194.

Promissory notes in Kansas that promise "to pay to the order of" the payee are "governed by the UCC," principally K.S.A. §§ 84-3-101, 84-3-102(a), 84-3-104, and 84-3-303. *Yancey*, 2009 WL 398988 at *3. "A note is issued for value if it is issued 'as payment of, or as security for, an antecedent claim against any person, whether or not the claim is due.'" *Id.* (quoting K.S.A. § 84-3-303(a)(3)). "If the note was issued for value, then the instrument was issued with consideration" and thus is enforceable in Kansas. *Id.* (citing K.S.A. § 84-3-303(b)). As such, even if the note is issued later for an earlier debt not represented by a note, the law of Kansas is that it is valid and enforceable. *Id.* (quoting K.S.A. § 84-3-303, Official UCC Comment 1, Case #1).

Moreover, in Kansas, "consideration for a written contract is presumed unless lack of consideration is raised as an affirmative defense and is proved by substantial competent evidence." *Id.* (citing *State ex rel. Ludwick v. Bryant*, 697

P.2d 858, 861 (Kan. 1985); K.S.A. § 16-108). The law of Kansas broadly defines "consideration" as "some right, interest, profit, or benefit accruing to one party." *Varney Bus. Servs. v. Pottroff*, 59 P.3d 1003, 1014 (Kan. 2002) (quoting 17A AM.JUR.2D *Contracts* § 113, p. 129).

In this case, as the bankruptcy court readily recognized, AFI's promissory notes to the Jenkinses would have been enforceable under the law of Kansas. There are four notes at issue in this case: one executed on December 6, 1999, for $500,000.00, another on November 6, 2000, for $500,000, a third on October 11, 2001, for $1 million, and a final one renewing the previous three on March 1, 2003, for $2,370,761.00 (Aplt.Appx.1090,1096,1150-51). Each states an interest rate, respectively 9.5%, 9.0%, 8.0%, and 8% (Aplt.Appx.1090,1096,1150-51). Each describes AFI as the "borrower" and states AFI promises to "pay to the order of" the Jenkinses the principal amount plus interest (Aplt.Appx.1090,1096,1150-51). Each states that its principal balance plus accrued interest is due five years from the date it was signed (Aplt.Appx.1090,1096,1150-51). Each expressly states a long paragraph of agreement by AFI to remain bound by it (Aplt.Appx.1090,1096,1150-51).

Kansas recognizes that these terms and covenants make for valid, enforceable promissory notes in all instances. *Thornton*, 132 P. at syll., 194; *Yancey*, 2009 WL 398988 at *3. At the same time, and as the Trustee admitted in his brief before the BAP, no Kansas court *ever* has approved the recharacterization of an express debt instrument as equity in some manner.

And each of the promissory notes here was supported by sufficient consideration. This is presumed in Kansas unless lack of consideration is raised as an affirmative defense by the adverse party and is proved by substantial competent evidence. *Ludwick*, 697 P.2d at 861; K.S.A. § 16-108. While the Trustee alleged in its adversary complaint that there was inadequate consideration for the notes (Aplt.Appx.41-42,47), the bankruptcy court did not find the Trustee had proven this by substantial competent evidence. Instead, it found in its judgment that "the Jenkinses provided the consideration for the purchase of AFI and related assets" (Aplt.Appx.221), and then *specifically rejected* the Trustee's argument:

> Under Kansas law, consideration is defined as "some right, interest, profit, or benefit accruing to one party"; "[a] promise is without consideration when the promise is given by one party to nother without anything being bargained for and given in exchange for it." The consideration need not have a value equivalent to the benefit received. "A consideration legally sufficient for any purpose at all, even the slightest consideration, is sufficient for whatever purpose the parties seek to use it." The Court rejects the Trustee's position that the assignment of the Cabanas Judgment as security for funds allegedly loaned to AFI was without adequate consideration.

(Aplt.Appx.230) (internal citations omitted).

Accordingly, the promissory notes were valid and enforceable under Kansas law, the "applicable law." § 502(b); *Travelers*, 549 U.S. at 451. They included the proper language and terms, were issued for value, and were supported by sufficient consideration. Thus, under § 502(b), the bankruptcy court "shall allow" the Jenkinses' claim against AFI for payment of the notes. *Id.*

Under the proper test, the bankruptcy court erred in recharacterizing AFI's promissory notes to the Jenkinses as notations of capital infusions. This Court should reverse the bankruptcy court's judgment granting the Trustee relief on Count I of its complaint.

B. Even under the multi-factor *AutoStyle/Hedged* test, the bankruptcy court erred in recharacterizing the promissory note debts as notations of capital infusions.

If, despite the Supreme Court's plain directions in *Travelers* and *Law*, the Court nonetheless holds that the multi-factor test of the Sixth and Eleventh Circuits' own creation nonetheless should be applied to this case, then the bankruptcy court still erred in recharacterizing the Jenkinses' loans to AFI redeemable through the promissory notes as capital infusions.

In holding that the Jenkinses' transfers to AFI in the promissory notes should be recharacterized as equity, the bankruptcy court purported to rely on the 13-factor test in *Hedged*, 380 F.3d at 1298-99, detailed *supra* at 33-34 (Aplt.Appx.210-18). *Hedged*, however, actually *supports* that the promissory notes in this case are actual loans and should not be recharacterized as equity.

The entity in *Hedged*, HIA, was "a stock investment Ponzi scheme." 380 F.3d at 1294. The scheme involved a group of equity investors who artificially pulled their investments from HIA in the form of a worthless check, which they in turn immediately offered back to HIA in return for a promissory note. *Id.* at 1295-96. The loan payment terms were nearly identical to the profit payments the company had promised to their limited equity investors. *Id.*

Nonetheless, even under those essentially *fraudulent* circumstances, nothing remotely as egregious as which even was alleged in this case, this Court held the promissory notes should not be recharacterized as equity and disallowed. *Id.* at 1299. This was true even though only six of the thirteen factors – less than half – indicated the loan should not be recharacterized. *Id.* Among these were that "the transaction documents drafted by the parties treat the funds as a loan and fulfill the proper formalities for a commercial loan," the payees "had the right to enforce payment of principal and interest," the payees "acquired no management control in exchange for its funds," the payees' "loan agreement did not subordinate it to HIA's other commercial creditors," and "the parties intended the transaction to be a loan." *Id.* Moreover the Court specifically discussed and evaluated factors it found would support recharacterization: (1) the absence of a fixed loan maturity date in the notes; (2) HIA's "thin" capitalization; and (3) HIA's payment of interest out of a pooled investment account. *Id.*

Despite all of this, the Court *still* held that the Ponzi scheme's loans should not be recharacterized. *Id.* The Court was concerned "that excessive suspicion about loans made by owners and insiders of struggling enterprises would discourage legitimate efforts to keep a flagging business afloat." 380 F.3d at 1298 n.1. It indicated that recharacterization, especially on the basis of "insider" loans to undercapitalized entities, should be disfavored, as insiders often make loans to aid struggling companies:

> Too heavy an emphasis on undercapitalization produces just such an unhealthy deterrent effect. Undercapitalization certainly remains an important factor to consider, but under the multi-factor approach we adopt today business owners need not fear, should their rescue efforts fail, that the bankruptcy court would give disproportionate weight to the poor capital condition of their failing companies and thus too quickly refuse to treat their cash infusions as loans.

Id.

Especially given these concerns, application of the *Hedged* factors in this case similarly supports *not* recharacterizing the Jenkinses' loans as equity. Indeed, likely for the concerns expressed in *Hedged*, until this case no court anywhere in this Circuit *ever* has approved of a recharacterization of a debt claim in bankruptcy as equity. This is not an appropriate case to be the first. Unlike in *Hedged*, where only six of the factors worked against recharacterization, here *ten* of the factors plainly belie recharacterization. They are as follows:

1. The names given to the certificates evidencing the indebtedness

The promissory notes at issue in this case plainly are titled "Promissory Notes" (Aplt.Appx.1090,1096,1150-51). The bankruptcy court noted this, too, holding this "support[s] treating the AFI notes payable to the Jenkinses as loans" (Aplt.Appx.213).

2. The presence or absence of a fixed maturity date.

The bankruptcy court found this factor favored recharacterization (Aplt.Appx.214-15). This was error. Each promissory note at issue plainly specified a fixed maturity date of five years from the date of issue (Aplt.Appx.1090,1096,1150-51). Each then offered further clarification in the event of non-payment, requiring full repayment "upon the reclamation bond release from the State of Missouri" (Aplt.Appx.1090,1096,1150-51). The bankruptcy court clearly erred in holding "the Notes in fact did not have a fixed maturity date" (Aplt.Appx.215).

3. The source of payments.

While the bankruptcy court quoted *Strinnett's* 1986 observation in the tax context that, "If the expectation of repayment depends solely on the success of the borrower's business, the transaction has the appearance of a capital contribution," 730 F.2d at 639, in the context of this case that is a tautology. If a person makes a loan to a struggling business, the business only ever will be able to repay the loan if it is "in the black," not "the red." This Court more recently has clarified that loans "to keep a flagging business afloat" are important and the state of the business should not factor into the recharacterization analysis. *Hedged*, 380 F.3d at 1298 n.1.

Here, the only business of AFI was "completion of reclamation" (Aplt.Appx.215). The promissory notes were to be repaid by AFI when the payments were due – after five years or, at the latest, upon completion of the reclamation (Aplt.Appx.1090,1096,1150-51). That the payment ultimately was secured by the certificates of deposit does not detract from this: the "loans were secured with liens, which obviated any need for a sinking fund." *AutoStyle*, 269 F.3d at 753. Thus, this factor supports the promissory notes being loans, not equity: the Jenkinses loaned the money to AFI with the expectation that AFI would pay them back, pursuant to the terms of the notes.

4. The right to enforce payment of principal and interest.

The plain language of the notes gave the Jenkinses the right to enforce payment of their principal and interest (Aplt.Appx.1090,1096,1150-51). The Jenkinses and Mr. Pommier both believed the Jenkinses had the right to enforce payments with interest when they were due pursuant to the notes. They plainly anticipated such enforcement when the Jenkinses and Mr. Pommier executed the 2003 note for $2,370,761.00 – renewing the previous three notes for principal and interest, instead of only $2,000,000, the total of the earlier notes' principal alone (Aplt.Appx.1151). Mr. Pommier signed the 2003 note, showing that he, too, believed Mr. Jenkins had the right to enforce payment of principal and interest (Aplt.Appx.1151). This supports the notes as loans, not equity.

In holding otherwise, the bankruptcy court focused on whether there was a "fixed obligation to repay the loan" (Aplt.Appx.215-16) (citing *Strinnett's*, 730 F.2d at 639). The plain language of the notes, however, *did* create such an obligation: after five years and/or upon completion of the reclamation (Aplt.Appx.1090,1096,1150-51). It was irrelevant whether AFI had the "ability to pay," and whether an attempt to enforce would be "futile," as the court observed (Aplt.Appx.215-16). The Jenkinses still retained the *right* to enforce the notes.

5. Participation in management flowing as a result.

The bankruptcy court correctly noted "there is no evidence that W.K. Jenkins increased his participation in the management of AFI as a result of the advancements" (Aplt.Appx.213). It held this factor "support[s] treating the AFI notes payable to the Jenkinses as loans" (Aplt.Appx.213). The evidence supported this, too: the Jenkinses left the day-to-day operation of AFI and Cimarron to Mr. Pommier, who was the sole employee of the companies (Aplt.Appx.473,694). The Jenkinses "did not intend on operating AFI;" rather, "the sole purpose for Jenkins' [*sic*] investments in AFI were to obtain the proceeds of the equipment of AFI, Cimarron, and the Bonds/Certificates of Deposit following AFI's reclamation projects as required by the Permits" (Aplt.Appx.93-84). As the court found, the

Jenkinses "delegated the day-to-day operation of AFI and Cimarron to Pommier" (Aplt.Appx.197).

6. The status of the contribution in relation to regular corporate creditors.

The bankruptcy court held this factor was "not relevant to this case" (Aplt.Appx.214). This was incorrect. This factor is relevant to *all* cases. As the court noted, this factor "addresses whether the advances were subordinated to claims of other creditors" (Aplt.Appx.214) (citing *AutoStyle*, 269 F.3d at 752). As with the creditors in *Hedged*, the Jenkinses' "loan agreement did not subordinate it to [AFI]'s other commercial creditors." 380 F.3d at 1299. Thus, just as in *Hedged*, in this case this factor supports the notes being loans, not equity infusions.

7. The intent of the parties.

The bankruptcy court found this factor favored recharacterization, as the "real purpose of [the three] notes was to secure Jenkins [*sic*] investments in AFI and Cimarron" (Aplt.Appx.93,216). But that is not what this factor means. Rather, it concerns whether the parties intended that the money be repaid pursuant to the instrument. *Hedged*, 380 F.3d at 1299. That is, whether "the parties intended the transaction to be a loan." *Id.* Plainly, Mr. Pommier and the Jenkinses intended the notes to evince loans and not an infusion of capital. As Mr. Pommier stated in a memo to Mr. Jenkins, any assets remaining after reclamation is complete and after all "borrowings" are repaid, would be divided between him and the Jenkinses (Aplt.Appx.456-57). AFI "borrowed" money from the Jenkinses – took "loans" from them – with the intention that it would repay the borrowings. The Jenkinses expected the same. As the parties intended the transactions to be loans, this factor supports the notes' existence as loans, not equity.

8. "Thin" or adequate capitalization.

The bankruptcy court found that the "thin capitalization of AFI is a factor strongly supporting recharacterization" (Aplt.Appx.216) (citing *AutoStyle*, 269 F.3d at 751). But "thin" and "adequate" are entirely subjective terms. Higher-risk lenders, such as the Jenkinses, are inclined to lower the bar when looking for adequate capitalization. In this case, the goal of AFI was to complete the reclamation of the Blue Mound Mine. The Jenkinses and Mr. Pommier determined there was sufficient capital to accomplish that goal.

Moreover, this Court warns against undercapitalization being a "strong" factor. *Hedged*, 380 F.3d at 1298 n.1. While it is "an important factor to consider," a court should not "give disproportionate weight to the poor capital condition of [a] failing company[y]" so as to "quickly refuse to treat [a lender's] cash infusions as loans." *Id.*

10. Source of interest payments.

The bankruptcy court found this factor was "not relevant to this case," as "there were no interest payments made" (Aplt.Appx.214). This misses the mark.

Though there were none made, the promissory notes provided they *would* be made (Aplt.Appx.1090,1096,1150-51). AFI was to pay the interest upon collection on the notes, either after five years or once the reclamation was complete (Aplt.Appx.1090,1096,1150-51). Additionally, AFI had pending litigation in the *Cabanas* lawsuit that offered a potential monetary source to make the interest payments. The interest payments did not depend on the success of AFI making continuous profits. Thus, this factor belies recharacterization of the loans as equity.

Additionally, the absence of a fixed interest rate and any possibility of interest payments is a strong indication that an advance was a capital contribution, rather than a loan. *AutoStyle*, 269 F.3d at 750. Conversely, in this case, the *presence* of a fixed interest rate on each note and the demand of interest upon the note's due date (Aplt.Appx.1090,1096,1150-51) indicate a debt, not an equity infusion. *Id.*

12. The extent to which the advance was used to acquire capital assets.

The bankruptcy court correctly held that this factor, too, supports treating the promissory notes as loans (Aplt.Appx.214). "[T]he use of funds to meet operating expenses is generally indicative of a loan. In this case, the advances were for AFI's operations, conducted through Cimarron, rather than for the acquisition of capital assets" (Aplt.Appx.214). If the funds were used to meet daily operating needs, that indicates bona fide indebtedness. *Stinnett's*, 730 F.2d at 638. Here, AFI paid all its expenses with money the Jenkinses loaned, including, unbeknownst to the Jenkinses, Mr. Pommier's $85,000 annual salary (Aplt.Appx.94,476).

Even under the now-superseded *AutoStyle*/*Hedged* test, the bankruptcy court erred in recharacterizing AFI's promissory notes to the Jenkinses as equity. As *Hedged* points out under truly egregious facts amounting essentially to fraud, the circumstances of this comparatively benign case simply do not warrant recharacterization. The majority of the factors are in the Jenkinses' favor.

C. The bankruptcy court's brief, alternative holding disallowing the Jenkinses' claim for purportedly insufficient evidence was clearly erroneous.

In a brief paragraph toward the end of its lengthy memorandum, after spending 25 pages discussing recharacterization and equitable subordination, the bankruptcy court found that "the Jenkinses have not fulfilled" their "burden of persuasion as to the … amount of the[ir] claim" (Aplt.Appx.227-28).

This seeming afterthought visibly was clearly erroneous in the face of the undisputed promissory notes and readily calculable debt therefrom. The Jenkinses agree, of course, that, under §§ 501(a) and (b) of the Code, they had "the ultimate burden of persuasion as to the validity and amount of" their claim. *In re Harrison*, 987 F.2d 677 (10th Cir. 1993). In this case, however, it was clearly erroneous –

and hypocritical – of the bankruptcy court to rely in detail on the specific facts and amounts in the Jenkinses' claims in determining the Trustee's issues of recharacterization and subordination but then to turn around and find in one paragraph that, outside of those issues, "the evidence [was not] sufficient for the Court to determine the amount owed to the Jenkinses" (Aplt.Appx.228).

The Jenkinses readily produced their promissory notes from AFI, and the Trustee admitted that AFI had executed the notes to the Jenkinses. The first, executed by AFI on December 6, 1999, was for $500,000 at 9.5% interest per year (Aplt.Appx.1090). A simple interest calculation made this $1,117,013.84 by October 31, 2008 (Aplt.Appx.63). The second, executed on November 6, 2000, was for $500,000 at 9% interest per year (Aplt.Appx.1150). A simple interest calculation made this $982,963.05 by October 31, 2008 (Aplt.Appx.66). The third, executed on October 11, 2001, was for $1 million at 8% interest per year (Aplt.Appx.1096). Again, a simple interest calculation made this $1,723,886.03 by October 31, 2008 (Aplt.Appx.1098).

Thus, the total of the three notes, plus interest, was $3,823,862.92 ($1,117,013.84 + $982,963.05 + $1,723,886.03 = $3,823,862.92). Indeed, based on exactly the same evidence the Jenkinses proffered as to the notes' value – a self-made ledger (Aplt.Appx.70) – the bankruptcy court held that the Jenkinses were "entitled to the proceeds of the certificates of deposit" (Aplt.Appx.225).

The Trustee did not dispute the accuracy of the copies of the three notes or the Jenkinses' interest calculations. He did not argue the copies of the notes in evidence were not true and accurate, Mr. Pommier did not actually sign them, AFI did not actually issue them, etc. Instead, he argued either (1) that the notes actually denoted capital infusions and should be recharacterized as equity or (2) that the Jenkinses' claim in the notes, secured by the *Cabanas* chose in action, should be equitably subordinated to the status of an unsecured claim.

Indeed, the bankruptcy court *found* the notes were true and accurate: that they "were executed by AFI upon the signature of [Mr.] Pommier, President/Secretary, are payable to Green Acres Farms or assigns, and bear the signature of W.K. Jenkins as a witness" (Aplt.Appx.201-02). The court described the notes just as they appeared and found they "were executed …" (Aplt.Appx.202). It discussed the notes' terms in detail (Aplt.Appx.202-04). Nothing anywhere in the factual findings of its judgment suggests anything other than it, like the Trustee, agreed that the Jenkinses' copies of the notes attached to their proof of claim and reintroduced at trial were true and accurate copies of the same, actually executed by AFI to the Jenkinses under the terms described (Aplt.Appx.201-04).

Moreover, throughout its discussion of both recharacterization and equitable subordination, the bankruptcy court accepted and applied the notes and their facial terms as true, accurate, and valid (Aplt.Appx.213-18,220-24). Only at the very end of its judgment does the court attempt thirdly to justify its disallowance of the Jenkinses' claim by suggesting they "have not provided sufficient documentation to prove the amount of their claim" (Aplt.Appx.227).

But what is good for the goose is good for the gander. The Jenkinses plainly (and without dispute) showed true and accurate promissory notes issued to them for what, by the time of trial, amounted to $3,823,862.92. Whatever the bankruptcy court's other findings were, plainly this amount sufficiently was proven adequately. To the extent the bankruptcy court concluded otherwise, its finding was clearly erroneous.

The Jenkinses' claim was valid and proven. The Court should not make this the first approval of recharacterization in Tenth Circuit history. Instead, it should reverse the bankruptcy court's judgment granting the Trustee relief on count I.

II. The bankruptcy court erred in equitably subordinating the Jenkinses' $3 million secured claim to the status of an unsecured claim, because the Jenkinses have an allowed claim and, as a matter of law, have not engaged in inequitable conduct. The Jenkinses' transfers to AFI were not substitutions for equity or risk capital and their claim, intended to be secured, would not cause injury to other creditors of AFI, none of whom hold secured claims.

Raised below and decided by the BAP (Aplt.Appx.264-66)

Standard of Appellate Review

"Although the [Jenkinses] appea[l] from the BAP's ruling, this court reviews the decision of the bankruptcy court." *In re C.W. Mining Co.*, 749 F.3d 895, 898 (10th Cir. 2014). This Court applies "the same standards of review that govern appellate review in other cases." *Id.* (citation omitted).

"Equitable subordination … presents a mixed question of fact and law." *In re Hedged-Invs. Asocs.*, 380 F.3d 1292, 1300 (10th Cir. 2004). The Court "review[s] the bankruptcy court's findings of fact for clear error and review[s] the lower courts' application of the legal test for equitable subordination *de novo*." *Id.*

* * *

Equitable subordination is a harsh punishment under which a bankruptcy court is empowered to reorder the existing priorities among creditors, making a previously superior claim inferior. But a court is barred from applying equitable subordination to a claim of an "insider" unless he or she engaged in manifestly unfair conduct and a degree of culpability. In this case, the Jenkinses did not engage in any unfair conduct with any degree of culpability. Nonetheless, principally because they were the only secured creditors of AFI, the bankruptcy court held their secured claim should be equitably subordinated. Was this error?

"The doctrine of equitable subordination … looks not to the substance of the transaction but to the behavior of the parties involved." *In re Hedged-Invs. Assocs.*, 380 F.3d 1292, 1297 (10th Cir. 2004). Under it, "the funds in question are still considered outstanding corporate debt, but the courts seek to remedy some inequity or unfairness perpetrated against the bankrupt entity's other creditors or investors by postponing the subordinated creditor's right to repayment until others' claims have been satisfied." *Id.*

Equitable subordination is governed by § 510(c) of the Code, which provides:

> Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may-
>
> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
>
> (2) order that any lien securing such a subordinated claim be transferred to the estate.

Id.

There are "three requirements that must be met for a court to exercise its equitable subordination power" under this statute: "(1) 'inequitable conduct' on the part of the claimant sought to be subordinated; (2) injury to the other creditors of the bankrupt or unfair advantage for the claimant resulting from the claimant's conduct; and (3) consistency with the provisions of the Bankruptcy Code." *Hedged*, 380 F.3d at 1300. All three must be met in order for equitable subordination to be allows. *Id.* "*The critical inquiry* is whether there has been inequitable conduct on the part of the party whose debt is sought to be subordinated." *Id.* (citation omitted) (emphasis in the original).

This is an incredibly difficult standard to meet. For this reason, no court in the Tenth Circuit *ever* has approved of an attempted application of equitable subordination. Indeed, in the only case in which a lower court attempted to do so, this Court reversed. *See In re Mid-Town Produce Terminal, Inc.*, 599 F.2d 389, 392 (10th Cir. 1979). And there, the circumstances were truly egregious, with a manifest insider manipulating his company so as to obtain a secured debt to the detriment of the other creditors. *Id.* at 390-91. Nonetheless, being ""unwilling to find a dominant shareholder may not loan money to a corporation in which he is the principal owner and himself become a secured creditor," this Court held subordination still would not lie. *Id.*

This case does not warrant becoming this Court's first application of equitable subordination. The bankruptcy court erred in holding that either of the first two requirements – inequitable conduct or injury to other creditors – was met.

If the Jenkinses were not "insiders" of AFI, their transactions did not rise to the level of fraud, misrepresentation, overreaching, or spoliation, negating any inequitable conduct. If they were insiders, they did not engage in unfair conduct with a degree of culpability, negating the same.

And either way, there was no injury to any other creditor as the law defines it. The bankruptcy court stated the injury was that the Jenkinses were the only secured creditors of AFI, and priority repayment of their secured loans would prevent other creditors from being paid. But that is *always* the case with any smaller company with only one secured creditor. Holding that constitutes "injury" *per se* would chill secured investments in failing companies in the future.

A. There was no inequitable conduct within the meaning of the three-pronged test.

Generally, "'Inequitable conduct' for subordination purposes encompasses three categories of misconduct: '(1) fraud, illegality, and breach of fiduciary duties; (2) undercapitalization; or (3) claimant's use of the debtor as a mere instrumentality or alter ego.'" *Hedged*, 380 F.3d at 1301 (citation omitted). If the allegation is "undercapitalization," however, "while undercapitalization may indicate inequitable conduct, undercapitalization is not in itself inequitable conduct." *Id.* at 1302. Only if an "insider lender" "exploits" "secret information" or misrepresents "the borrower's health" through "trickery" is undercapitalization part of the inquiry. *Id.* at 1302-03.

Still, "different levels of scrutiny" are applied "to 'insiders' and 'non-insiders' of the debtor corporation." *Id.* at 1301. "Where the claimant is an insider or a fiduciary, the party seeking subordination need only show some unfair conduct, and a degree of culpability, on the part of the insider." *Id.* Conversely, "If the claimant is not an insider or a fiduciary …, the party seeking subordination must 'demonstrate even more egregious conduct such as gross misconduct tantamount to fraud, misrepresentation, overreaching or spoliation.'" *Id.* at 1301-02 (citation omitted). "[I]f the debtor is a corporation," the Code defines an "insider" as a: "(i) director of the debtor; officer of the debtor; [or] person in control of the debtor." § 101(31)(B).

1. The Jenkinses were not insiders of AFI, and there is no evidence of the gross misconduct tantamount to fraud, misrepresentation, overreaching, or spoliation required of non-insiders.

In this case, the bankruptcy court held that the "Jenkinses, as the equitable owners of 100 per cent of AFI and 99 per cent of Cimarron, were insiders of AFI," because their shares put them "in control of AFI" (Aplt.Appx.221) (citing § 101(31)). But it is well-established that a claimant's ownership of 100% of the stock of the debtor, standing alone, is insufficient to make the claimant into a "person in control" of the debtor such that he becomes an insider. *In re Kan. City Journal-Post Co.*, 144 F.2d 791, 802 (8th Cir. 1944) (where stranger to corporation acquired all the stock, and in the same transaction also acquired at a discount all the corporation's bonds secured by corporate property, it did not make him an "insider" or constitute fraud upon the corporation's general creditors).

Plainly, in this case, the Jenkinses were not actually *in control* of AFI within the meaning of § 101(31)(B). Mr. Pommier, AFI's president, was. The Jenkinses left the day-to-day operation of AFI to him, the sole employee (Aplt.Appx.473,694). The Jenkinses "did not intend on operating AFI;" rather, "the sole purpose for Jenkins' [*sic*] investments in AFI were to obtain the proceeds of the equipment of AFI, Cimarron, and the Bonds/Certificates of Deposit following AFI's reclamation projects" (Aplt.Appx.93-94). Mr. Pommier handled "the day-to-day operation of AFI and Cimarron" (Aplt.Appx.197).

Mr. Jenkins simply had no role in the operations of AFI and Cimarron. Rather, Mr. Pommier simply asked Mr. Jenkins when AFI needed money and Mr. Jenkins, attempting to allow AFI to achieve its sole remaining goal of completing the reclamation of the Blue Mound Mine, obliged (Aplt.Appx.524). Mr. Jenkins would write AFI a check and, as is typical of check drafters, did not wait to see how Mr. Pommier endorsed it (Aplt.Appx.524). At the end of each year, the two would come together and document the monies the Jenkinses loaned to AFI and execute promissory notes (Aplt.Appx.525).

This did not make the Jenkinses into "insiders" or their seeking to claim AFI's loans due to them a "breach of fiduciary duties." *Kan. City Journal-Post*, 144 F.2d at 802 (refusing to subordinate claim of 100% owner of failing debtor's stock who also purchased debtor's bonds at discount, as owner was not insider and did not breach fiduciary duties). Rather, the Jenkinses were non-insiders. *Id.* As such, to demonstrate "inequitable conduct," the Trustee had to "demonstrate even more egregious conduct such as gross misconduct tantamount to fraud, misrepresentation, overreaching, or spoliation." *Hedged*, 380 F.3d at 1300-01.

The Trustee did not meet this burden. And as the bankruptcy court erroneously held the Jenkinses were "insiders," it did not find any "gross misconduct" to the required level, either (Aplt.Appx.221). The Trustee did not even allege the Jenkinses had committed fraud, misrepresentation, overreaching, or spoliation (Aplt.Appx.29-56). This was because its request for equitable subordination was predicated *entirely* on the Jenkinses being insiders (Aplt.Appx.47). As the Jenkinses manifestly were *not* "insiders" of AFI within the meaning of that term in bankruptcy law, however, the bankruptcy court erred in finding they met the first requirement of "inequitable conduct."

2. Even if the Jenkinses somehow were insiders of AFI, there is no evidence of the required unfair conduct and degree of culpability.

Even if the Jenkinses somehow were considered "insiders" of AFI, the bankruptcy court's finding that they had engaged in inequitable conduct still was error. The Jenkinses did not engage in any sufficiently culpable conduct to qualify for equitable subordination.

To make a prima facie showing of inequitable conduct, the Trustee had to "present material evidence of unfair conduct" and demonstrate some culpability on the Jenkinses' part. *Hedged*, 380 F.3d at 1302. The bankruptcy court held the Trustee satisfied this only because: (1) the Jenkinses "arranged for ownership of their interest in AFI to be held by a straw man … because W.K. Jenkins was legally blocked from owning the stock of a surface coal mining company by the Federal Office of Surface Mining's Application Violator System;" (2) "the Jenkinses' 'loans' to AFI were in fact substitutions for equity or risk capital;" (3) "W.K. Jenkins has not accounted for sales of assets of AFI or its operating company, Cimarron;" and (4) "W.K. Jenkins exercised his control over AFI to cause AFI to assign $3 million of the approximately $5 million net recovery from the Cabanas Lawsuit to secure his transfers to AFI" (Aplt.Appx.221-22).

These reasons do not legally constitute "inequitable conduct" with a requisite degree of culpability. First, the evidence was *not* that Mr. Jenkins was "legally blocked from owning" AFI's stock. Rather, it was that the AVS system blocked him from being "an owner, operator of a service [*sic*] coal mining *operation* in the United States" (Aplt.Appx.644) (emphasis added). As such, Mr. Jenkins "could not own the stock in a company that was *going to continue to operate*" (Aplt.Appx.644) (emphasis added). But since he "didn't intend to operate [AFI] but only complete the reclamation," "that didn't really affect him"

(Aplt.Appx.645). Still, Mr. Pommier said "there was a chance that it might and I informed [Mr. Jenkins] of that" (Aplt.Appx.645), which is why *he* "advised [Mr. Jenkins] not to take the stock [of AFI] in his name" (Aplt.Appx.92,645).

That is not "inequitable conduct." It is prudent business-sense. There was nothing unfair about this. Even if there were, it does not show *Mr. Jenkins* had any culpability; he was following the advice that Mr. Pommier *admitted* giving to him.

Second, the court's reliance on its recharacterization of the debts as equity is flawed, as explained in detail *supra* in Issue I. The Jenkinses' loans to AFI were loans, not "substitutions for equity or risk capital." Indeed, the bankruptcy court itself held that as, without their loans, AFI would never have been able to complete the reclamation of the Blue Mound Mine, the Jenkinses' "transfers to AFI were beneficial to AFI and its bonding company creditors" (Aplt.Appx.223).

Third, there was no evidence that the Jenkinses actually had sold any of AFI or Cimarron's equipment. In fact, the Jenkinses have never seen a single penny from their investments in AFI or Cimarron (Aplt.Appx.598). The entire point to their claim in AFI's bankruptcy is finally to recoup their loans, which have never been repaid. The Jenkinses *could not* have provided an accounting for sales of assets of AFI or Cimarron, because they were not involved in any such sales. Mr. Pommier never would have provided such an accounting to the Jenkinses, considering he kept his $85,000 salary secret from them, too (Aplt.Appx.476).

Indeed, this is merely more proof that the Jenkinses were not "insiders." If anyone would have had the accounting records the bankruptcy court held were missing, it was the Trustee's own witness, Mr. Pommier, President of both AFI and Cimarron.

Finally, the assignment of the *Cabanas* judgment was not "inequitable conduct." Mr. Pommier readily agreed to the assignment in exchange for the Jenkinses' continuing to fund AFI, and as security for their by-then $3 million worth of loans (Aplt.Appx.480). There is nothing inequitable about an insider having security for propping up a failing entity. *Mid-Town Produce*, 599 F.2d at 390-91; *Kan. City Journal-Post*, 144 F.2d at 802.

"Insiders" or not, the bankruptcy court erred in holding the Jenkinses engaged in "inequitable conduct." The Court should reverse its judgment granting relief on Counts II, V, and VI of the Trustee's complaint.

B. There was no injury to the other creditors of AFI or unfair advantage for the Jenkinses.

Beyond "indequitable conduct," the adversary also must prove "injury to the other creditors of the bankrupt or unfair advantage for the claimant resulting from the claimant's conduct." *Hedged*, 380 F.3d at 1300. In this case, the *only* reason the bankruptcy court expressed for finding such an "injury" was that "The judgment in the Cabanas Lawsuit is the only source of funds for the payment of administrative expenses and unsecured claims, most of which predated the

Jenkinses' acquisition of AFI," and thus the Jenkinses have "an unfair preference over other creditors, including administrative expense claimants" (Aplt.Appx.223).

Essentially, then, the bankruptcy court held it is unfair that the Jenkinses were the only secured creditors of AFI, as opposed to other, unsecured creditors, who only would be paid after the Jenkinses. But no other small, failing entity with only one secured creditor would be any different. Under the bankruptcy court's logic, *all* such secured creditors would have an "unfair advantage" over earlier, unsecured creditors. But this reasoning has the potential to "discourage legitimate efforts to keep a flagging business afloat," *Hedged*, 380 F.3d at 1298 n.1, such as the Jenkinses' "beneficial" attempt to do so with AFI (Aplt.Appx.223).

That AFI granted the Jenkinses a security interest in exchange for their efforts to make it possible for AFI to complete reclamation of the Blue Mound Mine is not "injury to other creditors" who *did not* do so. As the court noted, most of the other creditors are "administrative expense claimants" (Aplt.Appx.223). Under its logic, however, those claimants' priority, whose claims arise *because* of the reclamation, should be superior to the Jenkinses' priority, without the loans from whom no reclamation could have been possible. If anything, *that* is unfair.

The Jenkinses' allowed, secured claim against AFI created no injury to other AFI creditors or unfair advantage to the Jenkinses. The bankruptcy court erred in holding otherwise.

Conclusion

The Court should reverse the bankruptcy court's judgment granting relief on counts I, II, V, and VI of the Trustee's complaint against the Jenkinses, and should remand this case with instructions to allow the Jenkinses' secured claim.

Oral Argument Statement

The issues in this case are complex and important, including one involving a circuit split. The interchange of oral argument would assist the Court in understanding and deciding them. Because of the intricacy of the issues on appeal, the Jenkinses request at least fifteen minutes for argument.

Respectfully submitted,

Jonathan Sternberg, Attorney, P.C.

by /s/Jonathan Sternberg

Jonathan Sternberg, Mo. #59533
911 Main Street, Suite 2300
Kansas City, Missouri 64105
Telephone: (816) 292-7000
Facsimile: (816) 292-7050
E-mail: jonathan@sternberg-law.com

COUNSEL FOR APPELLANTS

Certificate of Compliance With Type-Volume Limitation,
Typeface Requirements, and Type Style Requirements

I hereby certify that this brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B), because this brief contains 13,968 words, excluding the parts of the brief exempted by Rule 32(a)(7)(B)(iii).

I further certify that this brief complies with the typeface requirements of Rule 32(a)(5) and the type style requirements of Rule 32(a)(6), because this brief has been prepared in a proportionally spaced typeface, Times New Roman size 14 font, using Microsoft Word 2013.

I further certify that the electronic copy of this Brief of the Appellant filed via the Court's ECF system is an exact, searchable PDF copy thereof, that it was scanned for viruses using Microsoft Security Essentials and, according to that program, is free of viruses.

/s/Jonathan Sternberg_________
Attorney

Certificate of Service

I hereby certify that on June 27, 2014, I electronically filed the foregoing using the Court's CM/ECF system which will send notification of such filing to the following:

Christopher John Redmond, christopher.redmond@huschblackwell.com;

P. Glen Smith, glen.smith@huschblackwell.com; and

Ingrid Wong, ingrid.wong@huschblackwell.com.

I also certify that, on June 27, 2014, I mailed a true and accurate copy of the Appellants' Appendix to the following:

Mr. P. Glen Smith
Husch Blackwell LLP
4801 Main Street, Suite 1000
Kansas City, Missouri 64112

/s/Jonathan Sternberg
Attorney

10th Cir. R. 28.2 Materials