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

REPLY BRIEF OF THE APPELLANTS

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In their first issue on appeal, Appellants William and M. Earlene Jenkins explained that the bankruptcy court erred in granting the Trustee relief on Count I of his complaint by recharacterizing as equity – and, thus, disallowing – their claim for $3,823,862.92 for three promissory notes, plus interest (Brief of the Appellants ("Aplt.Br.") 8, 29-56).

As the Jenkinses showed, the notes were valid, enforceable, and collectable under Kansas state law (Aplt.Br. 40-44). As a result, under *Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443 (2007), and *Law v. Siegel*, 134 S.Ct. 1188 (2014), and as the Fifth and Ninth Circuits, applying *Travelers*, have recognized, § 502(b) of the Bankruptcy Code required the bankruptcy court to accept and allow the Jenkinses' claim as a valid debt, and the bankruptcy court's equitable powers under § 105(a) of the Bankruptcy Code did not provide it a means to undermine § 502(b)'s mandate (Aplt.Br. 29-44). The Jenkinses also showed recharacterization was error even under the earlier, 13-factor test this Court adopted in *In re Hedged-Invs. Assocs.*, 380 F.3d 1292 (10th Cir. 2004), as the notes plainly were formal loans to them similar to those not warranting recharacterization in *Hedged* (Aplt.Br. 44-53).

In response, the Trustee argues *Travelers* and *Law* did not reiterate that the sole test in federal bankruptcy law for whether a claim is a valid debt is whether the relevant state law would recognize it as such, and the Ninth and Fifth Circuits were wrong to hold otherwise (Brief of the Appellee ("Aple.Br." 26-36).[1] Further, though the Trustee admits he is unable to find even a *single* Kansas case "recharacterize[ing] a purported promissory note as a disguised infusion of equity," he insists that the law of Kansas provides for this anyway as to the notes at issue here (Aple.Br. 36-38). Finally, as to the *Hedged* test, the Trustee merely parrots the bankruptcy court's conclusions (Aple.Br. 38-46), ignoring the Jenkinses' explanation as to how, under *Hedged*, those findings did not warrant recharacterization (Aplt.Br.44-53).

The Trustee's arguments are without merit. *Travelers* plainly holds (as the Fifth and Ninth Circuits recently have reiterated) and *Law* plainly cements that the *only* test of whether a bankruptcy claim is enforceable as a debt is whether it is recognized as such under state law. *No* Kansas authority supports the notion that a valid, enforceable, collectable promissory note, which, as the bankruptcy court

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[1] Along with his brief, the Trustee filed a three-volume, 887-page separate appendix, most of which consists of copies of documents that already are in the Jenkinses' appendix. In his brief, though, the Trustee cites to only nine of those 887 pages – about one percent (Aplt.Br. 5, 9, 11-13, 22, 23) (citing Aple.Appx. 1569, 1649, 1654-55, 1893, 1924-25, 2183, 2251). The whole materials in which those nine cited pages occur comprise only 224 pages, or about 25% of the separate appendix. As the remaining 663 pages are uncited at all, the Trustee could have filed at least a 75% smaller appendix. The Jenkinses are forced to conclude that the Trustee's overly gargantuan appendix is simply an attempt at puffery. That is, in order to make his case look more "substantial," the Trustee chose to deluge the Court with a huge mass of unnecessary paper.

held here, meets all the formalities required by Kansas law, somehow can be recharacterized as equity, rather than debt, in a collections action. Under Kansas law, the Jenkinses' notes from AFI would be enforceable. Thus, under *Travelers* and *Law*, so, too, must they be enforceable as a claim on AFI's bankruptcy estate.

Nor do the Trustee's arguments as to how the 13-factor *Hedged* test ought to be applied fare any better. The point to that test is recharacterization is disfavored and cannot be used to "discourage legitimate efforts to keep a flagging business afloat." *Hedged*, 380 F.3d at 1298 n.1. The Jenkinses already have shown how, as a matter of law, the bankruptcy court's findings ran afoul of *Hedged*, itself, reaching exactly the conclusion that *Hedged* warned against – and under truly egregious circumstances in that case. The Trustee's response, parroting the bankruptcy court's findings largely without comment, does not explain otherwise.

Nothing in the Trustee's brief refutes the facts or law the Jenkinses already addressed. This Court should reverse the Bankruptcy Court's judgment granting the Trustee relief on his Count I.

A. *Travelers* and *Law* make plain that the only test of whether a bankruptcy claim is enforceable as debt is whether it is recognized as such under state law – in this case, under the law of Kansas.

While "recogniz[ing]," as the Jenkinses already explained, that "the Fifth and Ninth Circuits" recently have taken positions contrary to his arguments (Aple.Br. 35), the Trustee argues that "neither *Travelers* nor *Law* abrogated the

Bankruptcy Court's ability to recharacterize claims" as equity, instead of debt, notwithstanding state law (Aple.Br. 31).

The Trustee argues that, despite the express language of *Travelers* and *Law* and the recent application of *Travelers* in the Ninth and Fifth Circuits to precisely the situation at issue in this case, a variety of older cases, mostly in the tax and criminal context, and all long predating *Travelers* and *Law* (some as much as 80 years old) allow federal bankruptcy courts to recognize a "substance over form" doctrine under §§ 105(a) and 1129 of the Bankruptcy Code that, regardless of state law, requires the bankruptcy courts to use tests of judicial creation to determine whether a debt claim is "in substance nothing more than disguised infusions of equity" (Aple.Br. 28-35). He argues this is because "the *Travelers* and *Law* decisions do not deal with recharacterization at all, or even mention the *Hedged-Investments* decision" (Aple.Br. 31).

The Trustee's argument is without merit. In their opening brief, the Jenkinses already discussed *Travelers* and *Law* in detail (Aplt.Br. 34-40). They will not repeat that discussion here. The point to *Travelers*, however, is to answer broadly the question of "what is 'debt' in bankruptcy." The Supreme Court's unanimous answer was emphatic: "the 'basic federal rule' in bankruptcy is that *state law governs the substance of claims* …." 549 U.S. at 450-51 (quoting *Butner v. United States*, 440 U.S. 48, 54 (1979)) (emphasis added).

That is, *in all cases*, regardless of whether some federal court might prefer using "a test of its own creation," as the Trustee begs this Court to do, "'[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 interest 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).

The Trustee strains to avoid this broad holding, properly reapplied to recharacterization claims by the Fifth Circuit in *In re Lothian Oil*, 650 F.3d 539, 542-44 (5th Cir. 2011), and the Ninth Circuit in *In re Fitness Holdings Int'l*, 714 F.3d 1141, 1147-49 (9th Cir. 2013). He argues "neither *Travelers* nor *Law* abrogated the Bankruptcy Court's ability to recharacterize claims" as equity infusions using its own peculiar tests, rather than valid debts under state law, because "*Travelers* addressed the allowance of claims enforceable under state law that are not expressly prohibited by the Code," and "*Law* dealt with a bankruptcy court order that directly contravened a Code provision" (Aple.Br.31-32).

This is untrue. As the Jenkinses explained in their opening brief, both decisions (as the Fifth and Ninth Circuits already have recognized for *Travelers*) are directly applicable to the question of whether, outside of a test under state law, a bankruptcy court is constrained to find that a debt claim is a valid debt, and not equity. Both plainly hold a bankruptcy court cannot do so.

Travelers merely reiterates the importance of the *Butner* rule. 549 U.S. at 450-51. In *Lothian Oil*, the Fifth Circuit observed that, under this rule, the analysis of "applicable law" is "an application of state law, unless Congress has stated otherwise." 650 F.3d at 543. Thus, only "[i]f a claim asserts a debt that is contrary to state law … [because] state law classifies the interest as equity rather than debt, then implementing state law as envisioned in *Butner* requires different treatment than simply disallowing the claim." *Id.* The Trustee admits *Travelers* held that claims "enforceable under state law that are not expressly prohibited by the Code" must be allowed (Aple.Br.32).

In an attempt to find something under the Code that requires recharacterizing a debt as equity under a peculiar federal test and *not* state law, the Trustee first turns to § 1129(b), the "absolute priority rule" that "requires that certain classes of claimants be paid in full before any member of a subordinate class is paid" (Aple.Br. 28) (quoting *In re Paige*, 685 F.3d 1160, 1183 (10th Cir. 2012)). The Jenkinses have no qualm with that rule. Plainly, orderly bankruptcy proceedings could not exist without it.

By the statute's plain language, though, the "absolute priority rule" of § 1129(b) simply is the familiar order of priority: secured creditors first are paid in full, then unsecured creditors, then equity holders. *In re Stephens*, 704 F.3d 1279, 1284 (10th Cir. 2013). This does not address the legitimacy of individual claims, however, and does not prohibit an investor or equity holder who *also* holds a secured debt claim from being paid first. Indeed, in *Hedged* itself, as well as numerous other cases the Jenkinses cited, *see, e.g.*, *In re Mid-Town Produce Terminal, Inc.*, 599 F.2d 389, 392 (10th Cir. 1979), this Court *approved* of an equity holder's first-priority claim against the bankrupt entity's estate. Section 1129(b) does not provide independent authority for recharacterization of such a debt claim held by an equity investor, nor does the Trustee cite any case in which § 1129(b) was held to do so.

Moreover, to accept the Trustee's argument, this Court would have to hold that obeying a separate, extra-statutory, non-state-law test of its own creation would allow for recharacterization. As the Fifth Circuit in *Lothian Oil* and the Ninth Circuit in *Fitness* recognized, *Travelers* proscribes exactly this. The restatement of the *Butner* rule in *Travelers* returns recharacterization questions, like all questions about the "nature" of a bankruptcy claim, to its proper inquiry: whether the claim is for a debt recognized by the relevant state law. *Fitness*, 714 F.3d at 1146-47.

As such,

> a court may not fashion a rule 'solely of its own creation' in determining what constitutes a 'claim' for purposes of bankruptcy. Rather, '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.

Id. at 1146 (citations omitted).

In arguing otherwise, the Trustee points to a pre-*Travelers* decision regarding recharacterization from the Fourth Circuit in *In re Dornier Aviation, Inc.*, 453 F.3d 225, 231 (4th Cir. 2006), as well as decisions in other contexts, such as tax and criminal, long antedating *Travelers* (Aple.Br.31-32, 34) (citing *Gregory v. Helvering*, 293 U.S.465 (1934); *Bohrer v. Comm'r of Internal Revenue*, 945 F.2d 344, 347 (10th Cir. 1991); *Rogers v. United States*, 281 F.3d 108, 1116-17 (10th Cir. 2002)). The tax and criminal cases, *Bohrer* and *Rogers*, are totally inapposite, and for obvious reasons do not cite the Bankruptcy Code or discuss the propriety of recharacterization of valid state-law debt claims under it.

As to *Dornier* and the other bankruptcy cases the Trustee cites (Aple.Br. 34), as the Fifth and Ninth Circuits have recognized, post-*Travelers* the earlier decisions' reasoning no longer rings true. In adopting multi-factor "tests" to determine "whether a claim should be treated as a claim or as an equity security interest" (Aple.Br. 32), those decisions do exactly what the Supreme Court expressly held in *Travelers* that bankruptcy courts *may not* do. 549 U.S. at 450-51 (quoting *Butner*, 440 U.S. at 57).

This Court now should join the Fifth and Ninth Circuits in abandoning the tests *Travelers* proscribes and should engage in the only analysis authorized under

Travelers to determine the "substance" of AFI's notes to the Jenkinses: the notes' validity, enforceability, and collectability under Kansas state law.

The Trustee also points to § 105(a) of the Code, which gives bankruptcy courts "inherent equitable powers" (Aple.Br. 29), and argues it, too, creates a "substance over form doctrine" that independently authorizes a bankruptcy court to "determinat[e] whether a claim should be treated as a claim or as an equity interest" (Aple.Br. 30). *Law*, which the Trustee dances around, equally bars that reasoning.

The Trustee barely addresses *Law* at all (Aple.Br. 29, 31-32). He merely argues *Law* is inapplicable because it "dealt with a bankruptcy court order that directly contravened a Code provision" (Aple.Br. 31-32).

But that is exactly what occurred here, too. The implications of *Law* on how § 105(a) operates are plain and deep. The point to *Law* is 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 (citation omitted). As the Jenkinses explained in their opening brief (Aplt.Br. 38-40), per *Travelers* § 502(b) of the Code mandates that bankruptcy courts "*shall* allow such claim" unless it "is unenforceable … under" state law.

As a result, the equitable power of § 105(a) "does not give courts discretion to grant or withhold [claims] based on whatever considerations they deem appropriate." *Law*, 134 S.Ct. at 1196. As *Travelers* explains, the *sole* consideration § 502(b) requires for whether a claim for debt can be disallowed is whether *state law* permits such a disallowance. The equitable powers of § 105(a) do not provide a way around this, as to allow otherwise would employ § 105(a) to "directly contraven[e]" the explicit mandate of § 502(a). The Trustee offers no response to this whatsoever, because he cannot.

As *Travelers* and *Law* make plain, whatever courts previously may have held, and regardless of the equitable powers of a bankruptcy court in § 105(a), under § 502(b) a validly-stated claim for debt is disallowable only if the relevant state law permits this. This Court should join the Fifth and Ninth Circuits, follow *Travelers* and *Law*, overrule *Hedged*, and determine whether AFI's notes to the Jenkinses were valid and enforceable under Kansas state law.

B. The law of Kansas does not in any way allow a court to recharacterize facially valid, enforceable, collectable loans as capital infusions.

In their opening brief, citing Kansas law in detail, the Jenkinses explained recharacterization in this case was error because "the promissory notes AFI executed to the Jenkinses were enforceable and collectible under Kansas state law," which the parties stipulated governed (Aplt.Br. 40-44). That is, as the bankruptcy court itself found, the notes included the proper language and terms, were issued for value, and were supported by sufficient consideration (Aplt.Br. 40-

44). Thus, the law of Kansas is these were "valid, enforceable promissory notes" (Aplt.Br. 42).

In response, admitting that "Kansas courts have" never "recharacterize[ed] a purported promissory note as a disguised infusion of equity," the Trustee nonetheless insists "Kansas courts stand willing and able to do so based on the substance of the transaction rather than the form" (Aple.Br. 36). He says this is because "[g]eneral corporate law supports the power and authority of the courts of Kansas … to review the relationship of the parties to a transaction and recharacterize a transaction between shareholders and the corporation as an infusion of equity rather than debt" (Aple.Br. 36-37).

The Trustee's arguments are without merit. First, of course Kansas state courts "posses[s] both law and equity powers which may be exercised in the same proceeding." *Mitchell v. Kelly*, 107 P. 782, 782 (Kan. 1910), and an ancient equitable maxim is that "equity regards substance rather than form." *Shelley v. State Dept. of Human Resources*, 8 P.3d 33, 37-38 (Kan. App. 2000).

But none of the few Kansas decisions the Trustee cites (Aple.Br. 36-37) in any way refused to allow a party to recoup a debt because the court recharacterized the party's facially valid debt instrument (let alone a legally sufficient promissory note) as some other, non-debt transaction. *See, e.g., id.*; *Hudson v. Gibbony*, 28

Kan. 612 (1882); *Atlas Indus., Inc. v. Nat'l Cash Register Co.*, 531 P.2d 41 (Kan. 1975); *N.H. Ins. Co. v. Fox Midwest Theatres, Inc.*, 457 P.2d 133 (Kan. 1969).

Indeed, *Shelley*, *Atlas*, and *N.H. Ins.* did not concern instruments even alleged to create a debt.

In *Shelley*, the "substance over form" language the Trustee cites pertained to the interpretation of a statute determining the length of time a state employee had worked; the court instructed that "a technical interpretation" of the statute's form had to yield to the obvious substance of its plain intent. 8 P.3d at 37-38.

In *Atlas*, a breach of purchase warranty action, the question was whether, for statute of limitations purposes, a lease of equipment executed at the same time as a purchase order for the equipment fell under Kansas's general civil statute or its UCC statute; because the lease and the purchase order had to be read together, the lease was a financing arrangement for the purchase of the equipment and fell under the UCC, and the purchaser was allowed to recover for the seller's breach of the warranties. 531 P.2d at 46-47.

In *N.H. Ins.*, insurance companies sued the lessee of a building to recover on a fire loss; because the obvious intent of the lease agreement required the lessor to maintain fire insurance, the lessee was not liable for the fire loss that resulted from its employees' negligence. 457 P.2d at 139.

Plainly, these decisions do not rise anywhere remotely to the level of recharacterizing a legally valid form of debt as an uncollectable equity transaction. And the Trustee's reliance on the 130-year-old *Hudson*, the only Kansas case he cites actually involving any debt instrument, is equally misplaced. There, the former owner of a piece of land brought a declaratory action to obtain money allegedly due on a mortgage to the land's new owner, which the parties had executed without consideration to replace the former owner's previous mortgage so as to give the old owner more time to pay that previous mortgage. 28 Kan. 612 at *1. After a judgment for the former owner, the Kansas Supreme Court remanded the case for a new trial but did *not* hold that the new mortgage was not, in fact, a debt instrument. *Id.* at *2. Instead, it held there was a question of fact as to whether or not the parties intended the new mortgage simply to replace the old mortgage. *Id.*

That the Trustee is unable to find *any* Kansas authority recharacterizing an express debt instrument as an equity infusion is unsurprising. Two more overarching equitable maxims are "*aequitas sequitur legem*" ("equity follows the law") and "*aequitas nunquam contravenit leges*" ("equity never contravenes the law"). While, in Kansas, courts certainly have equitable powers, these are trumped where the issue involved is legal: "Equity follows the law and cannot be invoked in matters plainly and fully governed by positive statutes." *Unified Sch. Dist. No. 207* *v. Northland Nat'l Bank*, 887 P.2d 1138, 1146 (Kan. App. 1994) (quoting *Pownall v. Connell*, 122 P.2d 730, Syl. ¶ 1 (Kan. 1942)).

As the Jenkinses explained in their opening brief, in Kansas the validity, enforceability, and collectability of a promissory note is a purely legal question directly addressed by Kansas statutes (Aplt.Br. 40-43). The Trustee offers no explanation otherwise. 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 always valid and enforceable in Kansas*. *Thornton Nat'l Bank v. Robertson*, 132 P. 193, Syl., 194 (Kan. 1913). Under Kansas law, the Trustee's response that Kansas courts retain equitable powers is irrelevant to the question of whether a valid promissory note can be rendered unenforceable in equity, because its enforceability is a legal question, not an equitable one. *Unified Sch. Dist.*, 887 P.2d at 1146 (quoting *Pownall*, 122 P.2d at Syl. ¶ 1).

Simply put, the law of Kansas is the Jenkinses' ability to collect on their express promissory notes from AFI has nothing to do with ancient equitable maxims. Rather, the Jenkinses bring a claim on a bankruptcy estate for enforcement of promissory notes issued to them for valid consideration by the bankrupt entity. Their claim on AFI's bankruptcy estate is a stand-in for a Kansas collection proceeding. And, in Kansas, the enforcement and collection of a promissory note is a legal matter governed by the UCC and standard, legal contract principles Kansas courts uniformly have announced and applied for over a century (Aplt.Br. 40-43).

Thus, because, in this case, and as the bankruptcy court found, AFI's notes to the Jenkinses included the proper language and terms, were issued for value, and were supported by sufficient consideration, the law of Kansas is they were "valid, enforceable promissory notes" (Aplt.Br. 40-44). The Trustee's argument otherwise is without merit.

C. The Trustee's mirror application of the *Hedged* test as the bankruptcy court would result in the same conclusion this Court warned against in *Hedged* and misapplies the test.

The Jenkinses also explained in their opening brief that, even applying the now-superseded *Hedged* test, the bankruptcy court's recharacterization of their loans to AFI redeemable through the promissory notes as capital infusions still was error (Aplt.Br. 44-53). They showed that the bankruptcy court's purported application of the *Hedged* test failed this Court's directives in *Hedged,* itself, which disapproved of recharacterization both generally and specifically in that case, under near-fraudulent circumstances with far more egregious allegations than those at issue in this case (Aplt.Br. 44-53). Exploring each of the *Hedged* factors in detail, the Jenkinses showed that, in the manner this Court directed the test be applied, a majority of factors weighed in their favor (Aplt.Br. 46-53).

In response, the Trustee also purports to explore the *Hedged* factors, but does not discuss the Jenkinses' arguments at all (Aple.Br. 38-46). Not once in any of his discussion does he cite to the Jenkinses' brief or mention anything the Jenkinses explained as to any of the factors (Aple.Br. 38-46). Rather, the Trustee merely parrots back the bankruptcy court's own purported analysis of the factors (Aple.Br. 38-46). But the Jenkinses already showed in detail how that analysis was wholly lacking and largely misconstrued the factors and the purposes behind them (Aplt.Br. 46-53). The Jenkinses will not reargue their opening brief. The Trustee's mirroring of the bankruptcy court leaves little to nothing for reply.

The Trustee does, however, harp on several themes that warrant a reply. First, he repeatedly mentions that, other than the proceeds of the *Cabanas* lawsuit and the certificates of deposit, AFI had no revenue to meet its daily needs besides the money from the Jenkinses secured by the promissory notes (Aple.Br. 40, 42, 44). At the same time, the Trustee acknowledges that the money only met daily needs and was *not* used to purchase additional capital (Aple.Br. 46). The use of the Jenkinses' loaned funds to meet daily needs in AFI's business of completing the reclamation and *not* to purchase additional capital supports the notes as a debt, not a capital infusion. *Stinnett's Pontiac Serv., Inc. v. Comm'r of Internal Revenue*, 730 F.2d 634, 638 (11th Cir. 1984). The Jenkinses were high-risk lenders to a struggling business; their funds were used to keep the business afloat day-to-day, and they expected the funds would be repaid. That is a loan, not a capital infusion.

Second, the Trustee repeatedly mentions that AFI had no source of revenue when the notes were executed, and the expectation was that the notes would not be repaid until the certificates of deposit were released, arguing that the Jenkinses' repayment was contingent on the "success" of the business (Aple.Br. 39-41). With a struggling entity like AFI, however, "success" is a relative term. AFI's main business at hand was completing the reclamation. While the Jenkinses did not seek to enforce the loans, knowing that AFI could not pay until the reclamation was complete, the notes still gave the Jenkinses the *right* to enforce them (Aplt.Appx. 1090, 1096, 1150-51). And this was a *fixed* obligation: by the notes' plain terms, the Jenkinses could enforce the notes *either* after five years *or* upon completion of the reclamation (Aplt.Appx. 1090, 1096, 1150-51).

Under the Trustee's theory, however, no lender *ever* could contract with their debtor for repayment upon completion of a project and, thus, receipt of enough money to pay, lest the lender risk recharacterization of his loan as a capital infusion. But this is precisely what this Court sought to avoid in directing how the *Hedged* test was to be applied: "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. The Jenkinses legitimately sought to keep AFI afloat so its operations could continue. If the Ponzi-scheme artists in *Hedged* were entitled to the benefit of the doubt, surely the Jenkinses must be, too.

Finally, and similarly, the Trustee persists that AFI was undercapitalized, and the Jenkinses owned 100% of its stock (Aple.Br. 44-45). Again, though, this Court in *Hedged* cautioned against these as being strong factors tending toward the disfavored action of recharacterization:

> 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.

380 F.3d at 1298 n.1. Once again, the Jenkinses explained this in their opening brief (Aplt.Br. 44-46, 51), but the Trustee does not respond to it at all.

The Jenkinses bought the stock of AFI, a failing entity, and loaned the business money secured by properly executed promissory notes. They acquired no control over the business's day-to-day operations. They did not run it as an "alter ego." They did not commit fraud. The parties intended the loans would be repaid pursuant to the notes' terms. Recharacterizing the loans as capital infusions would chill high-risk lending to failing businesses in the future.

Even under the now-superseded *Hedged* text, properly applied and with its purposes well in mind, the bankruptcy court erred in recharacterizing AFI's promissory notes to the Jenkinses as equity. This Court should not allow the recharacterization. It should reverse the bankruptcy court's judgment granting the Trustee relief on his Count I.

D. The bankruptcy court's holding that the Jenkinses failed to meet their burden to prove the amount of their claim was clearly erroneous.

In their opening brief, the Jenkinses also explained that the bankruptcy court's short paragraph toward the end of its memorandum holding "the Jenkinses have not fulfilled" their "burden of persuasion as to the … amount of the[ir] claim" was clearly erroneous, especially in light of the bankruptcy court's previous findings as to the promissory notes (Aplt.Br. 53-56) (citing Aplt.Appx. 227-28).

This finding was clearly erroneous because the amount of the Jenkinses' claim was readily calculable from the face of the undisputed promissory notes, which the bankruptcy court expressly found were supported by sufficient consideration (Aplt.Br. 53-56). The bankruptcy court's finding that the Jenkinses had not proved that amount was hypocritical, considering its reliance on the specific facts and amounts in the Jenkinses' claims in determining whether the notes should be recharacterized and whether the Jenkinses' claim should be equitably subordinated (Aplt.Br. 53-56).

In response, and not citing the record at all, the Trustee argues the bankruptcy court's finding that the Jenkinses did not meet their burden of persuasion was correct because "[t]here was no correlation between the amount of the Notes and the worksheets submitted by Jenkinses [*sic*]," "[t]here were no contemporaneous records produced connecting the Notes to the worksheets or checks," and "[t]he evidence is AFI received no benefit" (Aple.Br. 47).

The Trustee *does not* argue that the Jenkinses copies of the notes were not true and accurate, Mr. Pommier did not sign them on behalf of AFI, or that AFI did not actually issue them. Rather, essentially, the Trustee's argument is that there was insufficient proof that the notes were made for valid consideration. This is without merit. As the bankruptcy court already had found, the law of Kansas was that the notes *were* made for valid, sufficient consideration.

The one paragraph holding the Jenkinses "ha[d] not provided sufficient documentation to prove the amount of their claim" stated that,

> 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. 227-28).

Outside that brief finding, however, the bankruptcy court *already* had held that the Jenkinses *had* loaned at least $3 million in value to AFI and, as a result, had a right to the assignment of $3 million from the *Cabanas* judgment that secured the notes (Aplt.Appx. 221, 230). Whether there was sufficient consideration was a question of state law, and,

> 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).

It was undisputed, as the bankruptcy court found, that the Jenkinses *did* loan money to AFI (Aplt.Appx. 228). As this was "even the slightest consideration" for the notes, the Jenkinses *did not* have to show a check register or like records corresponding precisely to the face value of the notes. As the bankruptcy court itself found, the notes, secured by the assignment of the *Cabanas* judgment, were supported by sufficient consideration. Thus, the consideration, however slight, was "sufficient for [the] purpose the parties [sought] to use it" – namely, the notes.

As a result, per the bankruptcy court's own findings, the promissory notes were valid and enforceable under Kansas law (Aplt.Br. 42-44). It is undisputed that they included the proper language and terms Kansas requires, and that they were issued for value. As to consideration, the one element the Trustee contests, the bankruptcy court already found there was all the consideration Kansas requires. The court's finding that the Jenkinses somehow had not adduced sufficient proof of the amount of their claim was clearly erroneous.

Reply as to Issue II

In their second issue on appeal, the Jenkinses explained that the bankruptcy court erred in equitably subordinating their secured claims to the status of ordinary, unsecured claims (Aplt.Br. 57-67). They explained this was because, as a matter of law, neither of the first two requirements necessary to activate equitable subordination – "inequitable conduct" or "injury to the other creditors" – was met (Aplt.Br. 60-67). They were not actually "in control" of AFI within the meaning of the Bankruptcy Code (Aplt.Br. 61-63), and, even if they somehow could be held to be, they did not engage in any "unfair conduct" within the meaning of the relevant law (Aplt.Br. 63-66). They also showed that the fact they were the only secured creditors of AFI is not "injury to the other creditors" within the meaning of the relevant law (Aplt.Br. 66-67).

The Trustee's response largely rests on the testimony of Larry Pommier (Aple.Br. 50-52). But the bankruptcy court expressly found Mr. Pommier was not "very credible" because he and Mr. Jenkins "openly displayed hostility toward one another," such that the court "relie[d] heavily on the exhibits" in deciding the case and disregarded Mr. Pommier's testimony (Aplt.Appx. 194). This Court "refrain[s] from … passing on the credibility of witnesses …." *Bannister v. State Farm Mut. Auto Ins. Co.*, 692 F.3d 1117, 1126 (10th Cir. 2012). And, as the Trustee did not cross-appeal, he cannot attack any portion of the bankruptcy court's judgment adverse to him. *Hansen v. Dir., Office of Worker's Compensation Programs*, 984 F.2d 364, 367 (10th Cir. 1993).

In arguing equitable subordination was proper, the Trustee attempts to analyze the Jenkinses' purported "inequitable conduct" only as insiders (Aple.Br. 48-56). He does not respond to the Jenkinses explanation that, if they were not "insiders," equitable subordination was improper because the "inequitable conduct would have to constitute "even more egregious conduct such as gross misconduct tantamount to fraud, misrepresentation, overreaching, or spoliation" (Aplt.Br. 61-63) (quoting *Hedged*, 380 F.3d at 1300-01). By not addressing that burden, the Trustee implicitly admits he could not meet it.

As to whether the Jenkinses were "insiders," the Trustee also does not address the Jenkinses' discussion of cases on point holding that the 100% shareholder of a company who is not in day-to-day control of the company (as the bankruptcy court found here (Aplt.Appx. 197)) does not qualify as being "in control" of the company and, thus, an insider within the meaning of § 101(31) of the Bankruptcy Code (Aplt.Br. 62-63) (citing *In re Kan. City Journal-Post Co.*, 144 F.2d 791, 802 (8th Cir. 1944)).

Supposing *arguendo* that the Jenkinses were "insiders," as the Trustee insists, however, then the Trustee still must "show some unfair conduct, and a degree of culpability" on the part of the Jenkinses to prove the requisite "inequitable conduct" (Aplt.Br. 64) (quoting *Hedged*, 380 F.3d at 1301). And "undercapitalization" is not enough unless the "insider lender" "exploits" "secret information" or misrepresents "the borrower's health" through "trickery" (Aplt.Br. 60) (quoting *Hedged*, 380 F.3d at 1302-03). The Trustee does not allege, nor did the bankruptcy court find, that the Jenkinses had relied on – let alone "exploited" – any "secret information" or misrepresented AFI's health to anyone, let alone through "trickery."

Left with its "insider" argument and with undercapitalization not being a factor, the Trustee argues the Jenkinses' "inequitable conduct" as "insiders" was in "breach[ing] [Mr. Jenkins's] fiduciary duty 'by repeatedly and convincingly stating that his purpose when operating AFI was to secure the release of the Certificates of Deposit for his personal benefit'" (Aple.Br. 51) (quoting Aplt.Appx. 221), which the Trustee argues injured other creditors by "deny[ing]" those creditors "the benefit of a long awaited payment on their claims" (Aple.Br. 55).

The problem with the Trustee's argument, though, is that the alleged conduct to which he points *still* is insufficient to rise to the level of "inequitable conduct" by an "insider" within the meaning of the relevant law. The alleged "inequitable" activity must be objectively "unconscionable." *Comstock v. Group of Institutional Invs.*, 335 U.S. 211, 229 (1948) (allowing claim of dominant shareholder in bankruptcy). To activate equitable subordination, there must be more than the "mere existence of an opportunity to do wrong;" rather, it requires "the *unconscionable* use of the opportunity afforded by the domination to advantage itself at the injury of the subsidiary [in order to] depriv[e] the wrongdoer of the fruits of his wrong." *Id.*

The "advance to a failing corporation by a dominant shareholder" is insufficient to meet this lofty burden. *Mid-Town*, 599 F.2d at 392. This is because, "[t]o hold the debt may be subordinated on that basis alone would discourage owners from trying to salvage a business, and require all contributions to be made in the form of equity capital," which is neither "desirable as social policy, nor required by the cases." *Id.* As such, "claims for loans by majority shareholders will not be subordinated to claims of other creditors absent inequitable conduct." *Id.*

In *Mid-Town*, the 100% shareholder of a small, failing company installed his son as president, who then immediately signed the shareholder over a security interest in the company's equipment and inventory – the only secured claim on the company. *Id.* at 390-91. No corporate minutes showed any authorization for the security agreement. *Id.* The bankruptcy court, and then the district court, allowed the claim but equitably subordinated it to all other creditors' claim. *Id.* at 390.

Despite this obvious insider dealing, this Court reversed. *Id.* It was "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," for the above-quoted reasons. *Id.* at 392. That behavior does not rise to the level of the "unconscionability" required to activate equitable subordination. *Id.*

Similarly, in *In re Castletons, Inc.*, 990 F.2d 551, 559 (10th Cir. 1993), this Court refused the equitable subordination of a 100% shareholder bank's secured claim, even though the bank had attached liens and otherwise entirely controlled the debtor to its own benefit and to the detriment of other creditors (e.g. that the other creditors' claims were lower in priority). The Court held that, despite the bank's overwhelming control of the debtor, the bank's security interest in all of the debtor's inventory was a "valid properly perfect and enforceable security interest," subordination of which would be "completely improper" because the bank was "simply exercising the contract rights that it had, and there's nothing wrong with that." *Id.*

Many other courts have come to this same conclusion: a dominant, controlling shareholder's use of his position to effect a secured lien is not "inequitable conduct" activating equitable subordination. *See, e.g., In re Rabex of Colo., Inc.*, 226 B.R. 905, 909-10 (D.Colo. 1998) (reversing equitable subordination of judgment lien against debtor's alter ego); *In re AtlanticRancher, Inc.*, 279 B.R. 411, 439 (Bankr.D.Mass. 2002) (refusing equitable subordination of insider's $125,000 advance to debtor only seven months prior to bankruptcy); *In re*

Equipment Equity Holdings, Inc., 491 B.R. 792, 840-43 (Bankr.N.D.Tex. 2013) (refusing equitable subordination of insiders' loans to debtor).

Conversely, the Trustee does not cite a single similar case in which equitable subordination was found or upheld *at all*, let alone in circumstances like those here. Likely, this is because "[e]quitable subordination under § 510(c) is an extraordinary remedy, to be sparingly employed." *Id.* at 841; *see also In re U.S. Abatement Corp.*, 39 F.3d 556, 561 (5th Cir. 1994).

And this is for good reason:

> Wrongful or unpredictable subordination spawns legal uncertainty of a particular type: the risk that a court may refuse to honor an otherwise binding agreement on amorphous grounds of equity. If a court wrongly subordinates a claim, other investors are sure to take heed. An investor will see that the chance she might not get her money back has gone up slightly. She will be less willing to lend or invest in the future; and the cost of credit will rise for all.

In re Lifschultz Fast Freight, 132 F.3d 339, 347 (7th Cir. 1997).

As this Court previously did in *Mid-Town*, 599 F.2d at 392, it should reiterate that the Jenkinses' loaning money to AFI as 100% shareholders – especially while never profiting – was insufficient to rise to the level of "inequitable conduct." The Jenkinses' loans were required to keep AFI afloat and allow it to complete the reclamation. But for the loans, AFI would be in a worse position today than it is. The Jenkinses' securing of their loans through promissory notes and the *Cabanas* judgment assignment were structured in a way that was consistent with the high risk associated with the Jenkinses' lending. AFI was always undercapitalized. The Jenkinses' loans allowed it to go on with its business.

Even if the Trustee somehow were able to meet his high burden to prove the requisite unconscionable "inequitable conduct," he certainly cannot prove that the Jenkinses' loans caused "actual harm" to AFI and the other, unsecured creditors. Essentially, the Trustee's only argument as to how the unsecured creditors were harmed was that the Jenkinses' claim is secured and the other claims are unsecured, and thus the Jenkinses will be paid first (Aple.Br. 54-55) (harm is that the Jenkinses "are now entitled to deny the [other] creditors … payment").

Plainly, though, that is insufficient to rise to the level of an "actual harm." An unsecured creditor always takes the risk that a secured claimant will come along later in time but earlier in priority. *Kan. City Journal-Post*, 144 F.2d at 802. "Courts have determined that th[e] requirement [of "actual harm"] is not satisfied where a claimant's infusion of funds enables the company to stave off financial difficulties for a period of time[,] … even where such efforts ultimately fail and the corporation is forced to seek bankruptcy protection." *Equipment Equity*, 491 B.R. at 846.

As in any other case with both secured and unsecured creditors, the unsecured creditors are lower in priority. But that always is the lay of the land and what an unsecured creditor risks happening. That is not the "actual harm" to which the relevant law refers, nor does the Trustee cite any authority otherwise.

The Jenkinses' allowed, secured claim against AFI created no injury to other AFI creditors or unfair advantage to the Jenkinses within the meaning of those terms in the relevant law. The Trustee did not meet its burden to prove so. The bankruptcy court erred in holding otherwise. This Court should reverse the bankruptcy court's judgment granting relief on Counts II, V, and VI of the Trustee's complaint.

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.

Respectfully submitted,

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/s/Jonathan Sternberg
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I hereby certify that on September 23, 2014, I electronically filed the foregoing using the Court's CM/ECF system which will send notification of such filing to the following:

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