IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF TEXAS
TYLER DIVISION

EOD
09/30/2005

IN RE:	§	
	§	CASE No. 01-61988
RALLY PARTNERS, L.P.	§	CASE No. 01-61989
RALLY PIPELINE CORP.	§	CASE No. 01-61987
RALLY PIPELINE MARKETING CO.	§	
	§	**CONSOLIDATED** under 01-61988
Debtors	§	
	§	CHAPTER 11

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	§	
RALLY PARTNERS, L.P.	§	
Plaintiff	§	
	§	
v.	§	Adversary No. 02-6202
	§	
	§	
INWOOD NATIONAL BANK and	§	
BARNETT FAMILY LIMITED	§	
PARTNERSHIP	§	
Defendants	§	

MEMORANDUM OF DECISION[1]

Now before the Court in the above-referenced adversary proceeding is the complaint of Rally Partners L.P. ("Rally" or the "Debtor") to recover certain transfers made by the Debtor to Inwood National Bank ("Inwood"), allegedly for the benefit of Barnett Family Limited Partnership ("BFLP"). Rally's objections to claims #18 and #19 filed by BFLP are also before the Court. Some elements of the complaint were

[1] This Memorandum of Decision is not designated for publication and shall not be considered as precedent, except under the respective doctrines of claim preclusion, issue preclusion, the law of the case or as other evidentiary doctrines applicable to the specific parties in this proceeding.

conclusively established in an order issued by this Court granting partial summary judgment.[2] With respect to the remaining trial issues, the Court has considered the evidence and arguments presented at trial and in post-trial briefs submitted by the parties. This memorandum of decision disposes of all issues pending before the Court.[3]

BACKGROUND

On or about October 1, 2000, Mike Parks, Mark Strawn, BFLP, and Rally Pipeline Corp. acquired Rally. Parks, Strawn, and BFLP (the "Borrowers") each acquired only limited partnership interests in Rally, but Parks also served as President of Rally Pipeline Corp., which was Rally's general partner. The partners acquired their interests from Bistineau Partners, Ltd. and Torch Enerstar Holdings, L.L.C. In order to understand the relationship among the Borrowers and the reasons why they structured certain transactions in certain ways, the background of Michael A. Barnett ("Barnett") becomes significant. Barnett, in addition to serving as the president of the general partner of BFLP, owned a controlling interest in Benchmark Bank, and had been employed as a banker for some thirty years at the time of trial. He had connections in the banking industry that enabled BFLP and the other Borrowers to gain access to capital that may not otherwise have been available. He was not, apparently, extremely knowledgeable about

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[2] *See* Order Granting Plaintiff's Motion for Partial Summary Judgment, entered March 13, 2004 (docket no. 47).

[3] This Court has jurisdiction to consider the complaint pursuant to 28 U.S.C. §1334 and 28 U.S.C. §157(a). The Court has the authority to enter a final judgment in this adversary proceeding since it constitutes a core proceeding as contemplated by 28 U.S.C. §157(b)(2)(A), (B), (H) and (O).

the specific energy industry in which Rally was involved.

In order to obtain the funds necessary to purchase the ownership interests in Rally, Messrs. Parks and Strawn, and BFLP borrowed $6,000,000 from Inwood (the "Inwood Loan"). Of the $6,000,000 in proceeds derived from the Inwood Loan, a total of $4,250,000 was wired directly to Bistineau Partners, Ltd. and Torch Energy Marketing, Inc. in satisfaction of the agreed purchase price, while the remaining $1,750,000 was wired directly to a bank account held by Rally. The Borrowers executed a promissory note to Inwood, dated September 29, 2000, to evidence their debt to Inwood. As security on the Inwood Loan, BFLP, Susan T. Barnett, and Barnett[4] granted liens to Inwood on property worth substantially more than $6 million. Rally was neither a maker nor a guarantor of the promissory note to Inwood, but Rally did grant Inwood a security interest in its only valuable asset, a Master Gas Purchase and Sale Agreement (the "Master Gas Contract ") which it had with Reliant Energy.[5] The parties stipulated that the value of the Master Gas Contract at the time it was pledged as collateral to Inwood was $2,504,250, though that entire value would clearly be decreasing as the 47 months then remaining under the term of the contract passed.

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[4] In addition to granting liens to Inwood, Barnett also individually guaranteed the Inwood Loan. *See* Plaintiff's exhibits 3 - 18.

[5] Inwood received from Reliant Energy a letter acknowledging the assignability of the Master Gas Contract. Had the Master Gas Contract not been fully assignable, it would have been nearly worthless as collateral. *See* Plaintiff's exhibit 23. On December 12, 2000, Inwood filed a UCC-1 form with the Texas Secretary of State evidencing its security interest in the Master Gas Contract. *See* Plaintiff's exhibit 22.

Rally filed a petition for relief under Chapter 11 of the Bankruptcy Code on August 22, 2001. The only party to make any payment on the Inwood Loan prior to Rally's bankruptcy filing was Rally itself. Rally made ten monthly payments on the Inwood Loan between October 30, 2000 and July 27, 2001, totaling $908,587.50.[6] These payments were made despite the fact that Rally was neither a maker nor a guarantor on the note. At the time of Rally's bankruptcy filing, a balance in excess of $5 million remained on the Inwood Loan.[7]

Rally, in exercise of its power as a debtor in possession, filed this complaint against Inwood and BFLP to avoid, pursuant to 11 U.S.C. §§544[8] and 548, both the

[6] The payments were made on the following dates and in the following amounts:

10/30/2000	$52,500.00
11/30/2000	$54,250.00
12/29/2000	$202,500.00
1/25/2001	$50,862.50
2/26/2001	$46,556.25
3/29/2001	$194,768.75
4/25/2001	$43,525.00
5/25/2001	$38,554.16
6/29/2001	$189,266.67
7/27/2001	$35,804.17
Total	$908,587.50

[7] Pursuant to his guarantor liability, Barnett eventually liquidated the collateral necessary to pay off the Borrowers' liability on the Inwood Loan.

[8] §544(b) incorporates applicable state law, and Rally asserts that the transfers are avoidable under the Uniform Fraudulent Transfers Act enacted at TEX. BUS. & COM. CODE §24.001 *et seq.* (Vernon 2002). Although the Uniform Fraudulent Transfer Act has a longer statute of limitations, the elements required for recovery under that provision are substantively the same as those under 11 U.S.C. §548. *See* TEX. BUS. & COM. CODE §§24.005, 24.008 and 24.009 (Vernon 2002); *see also Floyd v. Dunson (In re Ramirez Rodriguez)*, 209 B.R. 424, 433 (Bankr. S.D. Tex. 1997) ["The [Texas] UFTA closely parallels the actual and constructive fraudulent transfer provisions of Sections 548(a)(1) and 548(a)(2) of the Bankruptcy Code, but provides for avoidance of fraudulent transfers within four years rather than the one year period allowed by the Bankruptcy Code."]; *see also*, *United States v. Klutts (In re Klutts),* 216 B.R.

transfer of the underlying security interest in the Master Gas Contract and the payments tendered by Rally to Inwood on the Borrowers' obligation. Rally does not assert actual fraud, but rather alleges that the transfers were constructively fraudulent because they were made in exchange for less than reasonably equivalent value as proscribed by §548(a)(1)(B). If avoidable under §§544 or 548, Rally further asserts that the transfers are recoverable under §550(a)(1) from both Inwood and BFLP jointly and severally, as Inwood was clearly the initial transferee of the transfers, and BFLP was an entity for whose benefit the transfers were made.

BFLP filed two claims in Rally's bankruptcy, and Rally responded with an objection to both claims. Claim #18 asserts a $6 million debt owed to BFLP by Rally. The claim indicates two bases of the debt: "Money Loaned" and "Other Investment." While BFLP asserted in its response to the objection to claim that the Borrowers always intended for the entire $6 million Inwood Loan to be a partnership loan which would be repaid by Rally using net income of Rally, it is uncontested that there is no documentary evidence of Rally's supposed obligation to repay any of that debt to either Inwood or to the Borrowers.[9] BFLP also asserted that if Rally was not liable for the entire $6 million

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558 (Bankr. W.D. Tex. 1997).

[9] BFLP contended that two documents demonstrated that at least the $1.75 million loan proceeds was a loan and not a capital contribution: the Amended and Restated Agreement of Limited Partnership of Rally Partners, L.P. provides for an initial capital contribution of $500 from BFLP and proscribes further capital contributions absent consent of the other partners; also, Rally's financial statements recorded the entire transaction as a $6 million liability. While this secondary evidence of the parties' intent may have some persuasive value, it does not constitute primary documentary evidence of the alleged obligation of Rally.

Inwood Loan, then Claim #18 should alternatively be allowed in the amount of $1.75 million, representing the amount of the loan proceeds Rally actually received.

BFLP's second claim, Claim #19, represents four short-term extensions of credit[10] allegedly made by BFLP to Rally during the two months preceding Rally's bankruptcy filing. These debts are evidenced by promissory notes signed by Parks as President of Rally Pipeline Corp., the general partner of Rally. Although the promissory notes are dated June 29, July 6, July 31, and August 6 of 2001, respectively, their evidentiary value is diminished by the fact that each was actually signed on August 20, 2001, just two days before Rally's bankruptcy filing.

In addition to asserting that both claims should be disallowed as capital contributions rather than actual debts for which Rally should justly be held liable, Rally contends that both claims should be equitably subordinated pursuant to 11 U.S.C. §510(c).

[10] These extensions of credit allegedly occurred on the following dates and in the following amounts (plus the pre-petition interest accruing at 8% per annum):

6/29/2001	$50,000.00
7/6/2001	$1,000.00
7/31/2001	$29,000.00
8/6/2001	$500,000.00
Accrued interest as of 8/22/2001	$2,495.34
Total	$582,495.34

DISCUSSION

As the resolution of the fraudulent transfer inquiry is somewhat dependent upon the characterization of the capital infusions reflected in Claim #18, the Court will first address the validity of the claims, and then proceed to examine the fraudulent transfer issues.

Claims Adjudication

A proof of claim, if it is executed and filed in accordance with the Federal Rules of Bankruptcy Procedure, constitutes *prima facie* evidence of the validity and amount of that claim, FED. R. BANKR. P. 3001(f), and is deemed allowed unless a party in interest objects under 11 U.S.C. §502(a). A proof of claim, however, does not qualify for that *prima facie* evidentiary effect if it is not executed and filed in accordance with the Bankruptcy Rules. *See First Nat'l Bank of Fayetteville v. Circle J Dairy (In re Circle J Dairy, Inc.)*, 112 B.R. 297, 300 (W.D. Ark. 1989). Rule 3001 generally sets forth the requirements for filing a proof of claim, and one of those requirements states that:

> when a claim . . . is based on a writing, the original or a duplicate shall be filed with the proof of claim. If the writing has been lost or destroyed, a statement of the circumstances of the loss or destruction shall be filed with the claim.

FED. R. BANKR. P. 3001(c). While Rule 3001 also provides specific rules for properly filing a claim if it represents a security interest, claims which are neither based on a writing nor a security interest must only comply with the basic requirements of FED. R.

BANKR. P. 3001(a) to gain a presumption of validity. *State Bd. of Equalization v. Los Angeles Int'l Airport Hotel Assoc. (In re Los Angeles Int'l Airport Hotel Assoc.)*, 196 B.R. 134, 139-40 (B.A.P. 9th Cir. 1996), aff'd 106 F.3d 1479 (9th Cir. 1997).

Hence, the burden of persuasion under the bankruptcy claims procedure always lies with the claimant, who must comply with FED. R. BANKR. P. 3001 by alleging facts in the proof of claim that are sufficient to support the claim. If the claimant satisfies these requirements, the burden of going forward with the evidence then shifts to the objecting party to produce evidence at least equal in probative force to that offered by the proof of claim and which, if believed, would refute at least one of the allegations that is essential to the claim's legal sufficiency. *See Lundell v. Anchor Const. Specialists, Inc. (In re Lundell)*, 223 F.3d 1035, 1041 (9th Cir. 2000); *Sherman v. Novak (In re Reilly)*, 245 B.R. 768, 773 (B.A.P. 2d Cir. 2000). This can be done by the objecting party producing specific and detailed allegations that place the claim into dispute, *see World Sav. & Loan Assoc. v. Lenz (In re Lenz)*, 110 B.R. 523, 525 (D. Colo. 1990), or by the presentation of legal arguments based upon the contents of the claim and its supporting documents, *see In re Circle J Dairy*, 112 B.R. at 300. If the objecting party meets these evidentiary requirements, then the burden of going forward with the evidence shifts back to the claimant to sustain its ultimate burden of persuasion to establish the validity and amount of the claim by a preponderance of the evidence. *See Consumers Realty & Dev. Co. v. Goetze (In re Consumers Realty & Dev. Co.)*, 238 B.R. 418 (B.A.P. 8th Cir. 1999); *In re*

Alleghany Int'l, Inc., 954 F.2d 167, 173-74 (3d Cir. 1992).

Claim #18 is not based on a writing, and therefore gains a presumption of validity by simply complying with FED. R. BANKR. P. 3001(a), which requires only that a claim be filed on a proper official form, as was Claim #18. While most debts for money loaned are evidenced by a writing, the underlying debt can still be valid absent such a writing. Thus, by virtue of the presumption of validity afforded by Rule 3001(f), the burden of going forward with the evidence shifts to Rally to produce evidence of at least equivalent probative value refuting the validity of the claim. Rally relies on legal argument to meet its burden, contending that the claim should be disallowed because it is based on an erroneous assertion that Rally is liable for a debt which it did not incur. BFLP responds by asserting that at all times all the Borrowers to the transaction intended the $6 million Inwood Loan to be a partnership loan for which the partnership, Rally, would be liable.

Despite BFLP's assertions about the intent of the Borrowers, it is clear that Rally had no legal obligation to repay the $6 million loan from Inwood to the Borrowers. Plain and simple, Rally was not obligated on the note. While the Borrowers may have contemplated that the source of repayment of the entire loan would be Rally's net income, such prognostications were in no way recorded as would be necessary not only to enforce the purported obligation but also to put Rally's myriad number of existing and potential creditors on notice that insiders would also be seeking payment of their obligations from the limited resources of the Debtor. Clearly Rally's legal argument is sufficient to shift the evidentiary burden back to BFLP to establish the amount and validity of the claim by a preponderance of the evidence.

In attempting to meet its burden, BFLP posits that, at the very least, it should be allowed a claim of $1.75 million representing the portion of the loan proceeds that were actually delivered to Rally. This position essentially is a request for the Court to construe the capital infusion provided by the Borrowers at the time they acquired Rally as a loan to Rally rather than as a capital contribution. The distinction between a loan and an equity contribution is often difficult to make, partly because "pure debt and pure equity lie at different ends of a spectrum with any number of variations in between." 14A William M. Fletcher, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §6970.39 (2000). Whether limited partners' cash infusions are to be treated as loans or capital contributions is a question of fact. *Park Cities Corp. v. Byrd*, 522 S.W.2d 572, 576 (Tex. App.– Beaumont 1975, writ granted) *rev'd on other grounds*, 534 S.W.2d 668, 670 (Tex. 1976). While the issue is a question of fact, the Fifth Circuit has endorsed a thirteen-point inquiry to assist courts in making that determination. *See Estate of Mixon*, 464 F.2d 394 (5th Cir. 1972) (deciding whether a cash infusion was a loan or a capital contribution for tax purposes); *Brazoria County Stewart Food Markets, Inc. v. Comm'r*, 48 Fed. Appx. 917 (5th Cir. 2002) (unpublished opinion).[11] A court should consider:

[11] While it seems state law should be applied to make this distinction, the dearth of state court opinions on the subject leads the Court to look to federal law applied in the Fifth Circuit for persuasive authority. Note that the Fifth Circuit treats the distinction between debt and equity investments as a question of law, while Texas state courts have held the issue is one of fact. *Compare Brazoria County*

(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 creditor and stockholder;

(10) source of interest payment;

(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.

Mixon, 464 F.2d at 402; *see also In re Cold Harbor Assoc., L.P.*, 204 B.R. 904 (Bankr. E.D. Va. 1997) [wherein a bankruptcy court used the thirteen factors commonly applied in tax cases to determine nature of a cash infusion for bankruptcy purposes]. No single element is either necessary or sufficient to definitively characterize an advance as a loan; neither should the court tabulate each element as if it constituted a point on a scorecard. Rather, the court should "consider all the factors and weigh the evidence favoring characterization of the advance as debt or equity...." *Id.*

When all thirteen factors are examined in light of the evidence in this case, only

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Stewart Food, 48 Fed. Appx. 917, *with Park Cities*, 522 S.W.2d 670.

three (factors 12, 13, and possibly 7) suggest that the $1.75 million cash infusion was a loan rather than a capital contribution. There is no question that the money infused was used to retire outstanding debts, and was not used to acquire capital assets. Similarly, there is no question that Rally actually made payments to Inwood for the benefit of BFLP and the other Borrowers. Also, the testimony at trial established that Barnett's subjective intent was to create a debt obligation for Rally. However, the Court must distinguish subjective intent and objective fact, for if one's stated subjective intent was always controlling as objective fact, any inquiry in this area would always begin and end with the labels by which the parties identified the instruments. *Id.* at 407. To determine intent as an objective fact, the Court must look beyond labels for some evidence indicating the intent of the parties at the time of the transaction. BFLP's position that the capital infusion was a loan finds some support in the documents executed by the parties when they were acquiring Rally. The Amended and Restated Agreement of Limited Partnership noted that the ownership interests of Rally Pipeline and the Borrowers were acquired through capital contributions totaling $1,000.00, and that no further capital contributions were contemplated or allowed absent approval of the other partners.[12] Nevertheless, finding as an objective fact that the intent of the parties was to create a loan rather than a capital contribution would be against the great weight of the evidence. As

[12] *See Amended and Restated Agreement of Limited Partnership of Rally Partners, L.P., A Texas Limited Partnership*, included in Plaintiff's exhibit 25. In light of the fact that the $1.75 million dollars contributed to Rally actually belonged to the Borrowers collectively, their approval is easily inferred.

president of BFLP, Barnett had thirty years' experience in the banking industry. He knew the importance of properly documenting a loan and yet he was unable to produce a shred of documentary evidence construing the capital infusion as a loan rather than a capital contribution. When asked at trial about the terms of the supposed loan to Rally, Barnett replied that the terms were "undefined."[13] Even if the Court were to accept BFLP's assertion that Rally had an obligation, though unrecorded, to repay the $1.75 million dollars it received, Barnett's testimony that the Borrowers fully expected Rally to make *all* the payments due to Inwood clearly demonstrates that the Borrowers did not contemplate a termination of Rally's obligation upon repayment of the sum of $1.75 million. The objective intent of the parties was not to create a loan for which Rally would be liable to BFLP or the other borrowers.

Turning to the other ten factors, the Court notes that there were no certificates evidencing the indebtedness (factor 1), no fixed maturity date (2), and no documented right to enforce payment of the supposed obligation (4). The source of the repayments was net income, indicating that this investment more closely resembled an equity contribution rather than a loan (3). BFLP gained some control over the entity in exchange for the cash infusion, as evidenced by a Voting Agreement entered into by Rally Pipeline Corp. and BFLP in consideration for the cash infusion (5).[14] While such consideration

[13] Trial transcript, page 59.

[14] "The parties acknowledge that [BFLP] has provided capital to the Partnership which is critical to the success of the Partnership, and in consideration for this investment, in addition to Barnett's limited

would be expected in exchange for an equity contribution, it would not be expected in the context of a loan. The alleged obligation was somewhat subordinated to trade debts (6), as would be equity, in that the payments contemplated would be drawn from net income of Rally, rather than from gross income. Also, the capital infusion came from all the Borrowers, displaying a unity of interest between the supposed creditors and the partners (9). As to factors (8), (10) and (11), insufficient evidence was presented to the Court to allow the Court to determine whether these factors support or undermine BFLP's claim. Considering all the factors, and the evidence related to them, the Court finds by a preponderance of the evidence that the initial capital infusion was not a loan to Rally, but was rather a capital contribution.

BFLP's assertion of the existence of a $1.75 million Rally obligation is clearly a post hoc attempt to reap the benefits BFLP sought when it entered into a precarious business relationship, despite Rally's current financial distress. If BFLP had accurately perceived the risks it faced in this investment, it could have taken the steps necessary to protect itself upon inception of the business relationship (such as demanding a promissory note from Rally). But failing to do so, this Court will not allow BFLP to shift the downside exposure of the investment to innocent third-party creditors by inferring a Rally obligation where there was none actually created. Hence, the Court finds that Claim #18 should be disallowed in its entirety, because BFLP has failed to meet its burden to show

partnership interest, the Company and Parks have entered into this [Voting] Agreement with Barnett." *See* Plaintiff's Exhibit #25.

that Rally was liable to repay any amount of the Inwood Loan either to Inwood or to BFLP.[15]

In contrast to Claim #18, Claim #19 is based on a writing. BFLP, by properly submitting duplicates of the writings upon which Claim #19 is based, complied with the requirements of FED. R. BANKR. P. 3001, and thus gained the benefit of the presumption of validity afforded by Rule 3001(f), and shifted the burden of going forward with the evidence to Rally. Rally again relied on legal argument to meet its burden, asserting that the cash infusions referenced in Claim #19, like that of Claim #18, represent capital contributions rather than loans.

Again applying the thirteen factors embraced by the Fifth Circuit, the Court must examine the totality of the circumstances to decide whether these cash infusions constitute loans or equity contributions. Many of the factors suggest these transactions were bona fide loans. The certificates evidencing the indebtedness were called promissory notes (factor 1). They all had specific maturity dates (2). Barnett testified that the parties intended that the cash would resolve temporary shortfalls caused by some disputed receivables, indicating that the source of repayments was defined specifically as

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[15] Even if the Court were to construe the capital infusion as a loan rather than a capital contribution, it is unclear how such a construction would change such an obligation from a debt owing to the Borrowers collectively (as owners of proceeds of the Inwood Loan) to a debt owing to BFLP individually. While perhaps BFLP's act of repaying the balance owning on the Inwood Loan at the time of Rally's filing would give rise to some equitable claim to subrogation, it seems likely that the other Borrowers would have some similar equitable claim to contribution from BFLP. Nevertheless, finding that the capital infusion was an equity contribution rather than a loan, these inquiries are beyond the scope of the issues pending before the Court.

the money to be recovered from such receivables (3). The promissory notes gave BFLP a means to legally enforce repayment (4). BFLP did not gain any additional control over the entity by virtue of the infusions (5). Repayment was in no way subordinated to other general accounts payable (6). The extensions were made only by BFLP, and therefore there was no unity of interest between the creditor and partners (9). Finally, the extension was used to pay outstanding accounts payable, and not to obtain capital assets (12). Factor (13) is irrelevant because the notes were not due prior to the date of the bankruptcy filing and there is no evidence that BFLP demanded repayment before the due dates. Factor (10) was not addressed by the evidence at trial.

Conversely, the evidence suggests that Rally was undercapitalized at the time the cash infusions were made, because the payments were necessary for Rally to meet its current liabilities (8). BFLP also concedes that it was "Rally's only apparent lending source..." (11).[16] Additionally, the objective intent of the parties that the transaction was a debt transaction is somewhat questionable in light of the fact that the notes were not timely executed (7).[17] These factors, however, are not sufficient to cause the Court to

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[16] Response of Barnett Family Limited Partnership to Objection to Proof of Claim Numbers 18 and 19 Filed by Debtor. Docket no. 264, ¶ 9.

[17] The Court is loathe to suggest that somehow claim #19 is more credible simply because Parks, on the eve of bankruptcy, signed BFLP's promissory notes. Such a suggestion would only encourage future investors in BFLP's position to seek eleventh hour promissory notes. However, even if the Court ignores the untimely executed documentary evidence, there are still factors which support Claim #19 (but not Claim #18): the source of repayment was specific accounts receivable as opposed to net income; no participation in management flowed from the infusions; the infusions were in no way subordinate to ordinary obligations of the partnership; and the infusions came from a single partner rather than from all the partners in amounts corresponding to their ownership interests.

accept Rally's characterization of the transaction, especially in light of the presumption of validity afforded by Rule 3001(f).

Finding that claim #19 should be allowed, however, does not end the dispute with respect to that claim. Rally contends that it should be equitably subordinated under 11 U.S.C. §510(c). Equitable subordination has long been an accepted means for a court to address a claimant's wrongful conduct. *Pepper v. Litton*, 308 U.S. 295 (1939). The remedy is appropriate where there is inequitable conduct by a claimant that either prejudices other creditors or confers an unfair advantage on the claimant. *Summit Coffee Co. v. Herby's Foods, Inc. (In re Herby's Foods)*, 2 F.3d 128, 130 (5th Cir. 1993); *see also United States Abatement Corp. v. Mobil Exploration & Producing U.S., Inc. (In re United States Abatement Corp.)*, 39 F.3d 556 (5th Cir. 1994) [noting that "Equitable subordination is a remedial, not penal, measure which is used only sparingly."]. However, even when the remedy is appropriate, claims "should be subordinated only to the extent necessary to offset the harm that the bankrupt and its creditors suffered as a result of the inequitable conduct." *Herby's Foods*, 2 F.3d at 131.

While it is possible that Rally was so undercapitalized in the months preceding its bankruptcy filing as to render the loans made by BFLP to Rally inequitable in nature, there is insufficient evidence to show that other creditors were prejudiced by these credit extensions. To the contrary, the only effect of BFLP's emergency extensions of credit was to free one set of unsecured creditors and replace it with another, namely BFLP.

There is no evidence that the total amount of Rally's unsecured debt increased over the two months preceding the bankruptcy filing, or that Rally's unsecured creditors were otherwise harmed by Rally's continued operations enabled by BFLP's loans. *Cf. Herby's Foods*, 2 F.3d at 130 (acknowledging that the unsecured float ballooned 500% as a result of insiders extending credit to an undercapitalized debtor). Absent any showing of harm to Rally or its other creditors, the Court will not subordinate Claim #19, but will instead allow the claim as a general unsecured claim.

Fraudulent Transfer Analysis

Rally asserts that the pledge of its Master Gas Contract to Inwood Bank, and also the loan payments which it made, are all avoidable as constructively fraudulent transfers. If that is correct, Rally asserts that the transfers are recoverable from Inwood as the initial transferee of the payments, and also from BFLP, one of the parties principally liable on the note, because BFLP was a party for whose benefit those payments were made. *See* 11 U.S.C. §550(a)(1).

To establish the existence of a constructive fraudulent transfer under 11 U.S.C. §548(a)(1)(B), a plaintiff must show: (1) the debtor transferred an interest in property; (2) the transfer of that interest occurred within one year prior to the filing of the bankruptcy petition; (3) the debtor was insolvent on the date of the transfer or became insolvent as a result thereof; and (4) the debtor received less than reasonably equivalent value in exchange for such transfer. *In re GWI PCS 1 Inc.,* 230 F.3d 788, 805 (5th Cir. 2000) (*citing In re McConnell*, 934 F.2d 662, 664 (5th Cir. 1991)). In the present case, in response to competing motions for summary judgment, the Court found that:

> (1) the Plaintiff's pledge of its primary asset, the Master Gas Contract, as well as the Plaintiff's payment of approximately $908,587.40 to Inwood National Bank under the promissory note, each constitute a transfer of an interest of the Debtor in property; (2) that each such transfer occurred within one year before the date of the filing of the petition; and (3) that the Debtor-Plaintiff was insolvent on the date of the transfers.

Order Granting Plaintiff's Motion for Partial Summary Judgment, entered March 16, 2004 [docket no. 47]. Hence, the only issue remaining for the Court at trial was whether the Debtor received reasonably equivalent value in exchange for the transfers.

To begin the analysis, a court must identify the transfer that a plaintiff seeks to avoid. In the present case, Rally seeks to avoid the original transfer of a security interest in the Master Gas Contract, and also the subsequent transfers of interest and principal payments totaling $908,587.50. One might assume that the entire transaction between Rally and Inwood should be evaluated as a single transfer, but case law does not mandate such treatment.[18] Furthermore, there are precedential and logical reasons to consider the

[18] In *Beemer v. Walter E. Heller and Co. (In re Holly Hill Medical Center, Inc.)*, 44 B.R. 253 (Bankr. M.D. Fla. 1984), the court compared the value of loan proceeds received by a debtor to the value of interest payments made by the debtor on the loan to determine whether the debtor received reasonably equivalent value in exchange for its interest payments. This suggests that a comparison between the proceeds of the Inwood Loan received by Rally and the payments made by Rally could be proper. However, the *Holly Hill* case did not involve any initial transfer on the part of the debtor to secure receipt of the loan proceeds. Thus, when the court began its inquiry by looking at the transfer which the debtor sought to avoid (i.e. the interest payments), the only value received by the debtor that the court could

transfer of the security interest and the subsequent loan payments separately. For example, as Inwood and BFLP acknowledge in their post-trial brief, it is possible that the loan payments could have been made in exchange for reasonably equivalent value, while the pledge of the Master Gas Contract was not. If the Court were to examine the entire transaction en masse, the proper analysis for one portion might be overlooked in order to construe the entire transaction as avoidable or unavoidable. It is improper to consider the cumulative effect of a series of transactions on the debtor entity; rather, a court should consider whether each transfer out was made in exchange for reasonably equivalent value. *Balaber-Strauss v. Sixty-Five Brokers (In re Churchill Mortgage Inv. Corp.)*, 256 B.R. 664 (Bankr. S.D.N.Y. 2000).

The Master Gas Contract Pledge

To determine whether Rally received reasonably equivalent value in exchange for its pledge of the Master Gas Contract, the Court must compare the value that accrued to Rally to the value that Rally transferred out, regardless of the source of the value transferred to Rally. *In re Fairchild Aircraft*, 6 F.3d 1119 (5th Cir. 1993); *Mancuso v. T. Ishida USA, Inc. (In re Sullivan)*, 161 B.R. 776 (Bankr. N.D. Tex. 1993). There need not be a dollar-for-dollar exchange for the transfer to be legitimate, but the Court must consider the net effect on the total assets of the debtor available to meet the demands of

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examine to consider reasonable equivalence was the loan proceeds. In contrast, Rally seeks to first avoid the transfer of a security interest. The allegedly reasonably equivalent value received in exchange for that transfer was the contemporaneous capital infusion. Wholly apart therefrom, Rally seeks to avoid the loan payments, and that exchange will be separately examined for reasonable equivalence.

creditors. *Sullivan*, 161 B.R. at 781.

The parties agree that the Master Gas Contract had a net present value of $2,504,250 at the time it was pledged as collateral on the Inwood Loan. However, it is inaccurate to state that Rally transferred $2,504,250 to Inwood when it pledged the Master Gas Contract as collateral. "A contingent liability cannot be valued at its potential face amount; rather, it is necessary to discount it by the probability that the contingency will occur and the liability become real." *Nordberg v. Arab Banking Corp. (In re Chase & Sanborn Corp.)*, 904 F.2d 588, 594 (11th Cir. 1990) (internal quotations omitted). In this case, therefore, Rally transferred a security interest worth something less than $2,504,250; more precisely, Rally transferred property worth $2,504,250 multiplied by (or discounted by) the probability that the Borrowers would default on the Inwood loan and Inwood would foreclose on this particular piece of its collateral. While it is unclear exactly what that probability was at the time the parties initiated the transaction, the Court recognizes that the loan was considerably oversecured by Barnett's assets and personal guaranty.

Having considered the value transferred out by Rally, the Court must next consider what value accrued to Rally's benefit in exchange for the pledge of its Master Gas Contract. As discussed above, $1,750,000 of the Inwood Loan proceeds were transferred directly to Rally in the form of a capital contribution. The funds were used to satisfy outstanding accounts payable. While capital contributions are not typically made *in* *exchange for* anything other than an ownership interest in an entity, the testimony in this case established that if Rally had not pledged its Master Gas Contract as security on the Inwood Loan, BFLP would not have involved itself in any portion of the transaction, much less made the capital contribution. Thus, the Court finds that the Master Gas Contract was pledged in exchange for the $1,750,000 capital contribution. At least one other bankruptcy court has followed a similar analysis, finding that where a corporate debtor received $369,288 of the proceeds of a $22,000,000 loan made to a controlling interest-holder, the debtor's guarantee of that loan was made in exchange for reasonably equivalent value. *Chase & Sanborn*, 904 F.2d at 594. While the evidence does not permit the Court to place a specific value on Rally's collateral pledge, it is clear that the value was not significantly greater than $1,750,000. Hence, the Court concludes that the Master Gas Contract was pledged in exchange for reasonably equivalent value, and such transfer is not avoidable under 11 U.S.C. §548(b).

The Inwood Loan Payments

As was the case with the collateral pledge, for the Court to determine the avoidability of the Inwood Loan payments, the only issue remaining is whether Rally received reasonably equivalent value in exchange for the payments. If Rally received reasonably equivalent value, the payments are not avoidable. If Rally did not receive reasonably equivalent value, the payments are avoidable under §548(b).

To determine whether reasonably equivalent value was received, the Court again compares the value transferred out by Rally to the value that accrued to Rally in exchange for that transfer. There is little question as to the value of the loan payments transferred out by Rally. As noted above, Rally made ten payments to Inwood in the ten months preceding the bankruptcy filing, totaling $908,587.50.

With respect to what was received in exchange for Rally's payments, BFLP contends that Rally's contingent liability was reduced. BFLP cites multiple cases wherein bankruptcy courts refused to declare interest payments on loans made to third parties avoidable, instead finding that the debtors received reasonably equivalent value in exchange for the interest payments. *Chase & Sanborn*, 904 F.2d at 594; *Bumgardner v. Simms (In re Simco Mech., Inc.)*, 151 B.R. 978 (Bankr. S.D. Fla. 1993); *Tidwell v. AmSouth Bank, N.A. (In re Cavalier Homes of Georgia, Inc.*), 102 B.R. 878, 885 (Bankr. M.D. Ga. 1989). However, in those cases the debtors had *actually guaranteed* the loans in question, and the courts accordingly found that the loan payments reduced the debtors' contingent guaranty liability. It was this reduction in the debtors' contingent liability that the courts found constituted reasonably equivalent value. While BFLP argues that Rally's pledge constituted a contingent liability similar to the guarantees in the cited cases, there is a significant difference between a guaranty and a collateral pledge. In Rally's case, each loan payment did nothing to reduce the amount that Rally would have to pay if the Inwood Loan fell into default. At all times relevant to the transaction, the worst-case scenario for Rally was that it would have to surrender the Master Gas Contract.[19] While each loan payment may have made that contingency marginally less likely, it did nothing to reduce the impact which a subsequent foreclosure would have on Rally's balance sheet. Even if this slight decrease in the likelihood of subsequent foreclosure provided some value to Rally, it simply strains the bounds of credibility to believe that such value was reasonably equivalent to the thousands of dollars paid by Rally in exchange. This case is clearly and significantly distinguishable from the guaranty cases cited by the BFLP, and the reasoning expressed in the guaranty cases is simply inapplicable to the present situation.

Finding the Inwood Loan payments avoidable under §548(b), they are also recoverable under §550. That section provides:

> Except as otherwise provided in this section, to the extent that a transfer is avoided under section ... 548 ...of this title, the trustee may recover for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from–
>
> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made.

11 U.S.C. §550. This section clearly provides that the Inwood Loan payments avoidable

[19] This would be the case at least until the theoretical moment when the loan balance fell below the value of the collateral. However, in this case the loan value never fell below the value of the Master Gas Contract, and indeed it never would have because the Master Gas Contract was constantly decreasing in value as time passed and the final month of the contract approached.

under §548 are recoverable from either Inwood or BFLP. The Court finds that both parties are jointly and severally liable for that recovery.

Conclusion

For the reasons stated above, the Court concludes that the allowance of Claim #18 is denied, while Claim #19 is allowed as a general unsecured claim in the amount of $582,495.34. The Court denies the Plaintiff-Debtor's request to equitably subordinate Claim #19. The Court further concludes that, while the pledge of the Master Gas Contract is not avoidable as a fraudulent transfer, the Inwood Loan payments made by Rally are hereby avoided and that, accordingly, BFLP and Inwood are jointly and severally liable to Rally in the amount of $908,587.50, plus pre-judgment interest accruing from the date of the avoidable payments at the rate of 3.88% per annum, together with post-judgment interest accruing upon such aggregate sum at the rate of 3.88% per annum until paid. A separate judgment will be entered on the complaint and appropriate orders entered on the claims objections which are consistent with this opinion.

Signed on 9/30/2005

THE HONORABLE BILL PARKER
CHIEF UNITED STATES BANKRUPTCY JUDGE