UNITED STATES BANKRUPTCY COURT
SOUTHERN DISTRICT OF ILLINOIS

IN RE: **KARL TINNEY, ROBIN TINNEY,** **d/b/a TINNEY TOOL & MACHINE,** **Debtors.**	)	**No.: 03-33633**
KENNETH M. KETTLER, **Plaintiff,** **vs.** **ESTATE OF DONALD TINNEY, Deceased,** **MARIE TINNEY, RON SPEISER and** **JEAN SPEISER,** **Defendants.**	)	**Adv. No.: 04-3132**

O P I N I O N

In 1993, Karl Tinney ("Debtor") became obligated to Kenneth Kettler ("Plaintiff") under a written lease agreement whereby the Plaintiff leased commercial real estate to the Debtor for a twenty-year period. At the end of 1996, the Debtor transferred the assets of his business to his wife ("Co-Debtor") and her corporation (Tinney Tool & Machine Company). In January 1997, citing financial failure, the Debtor terminated the lease.

In 1999, the Plaintiff filed suit in state court against the Debtor and the Co-Debtor (jointly referred to as "Debtors") and her corporation seeking judgment in his favor on the terminated lease agreement and avoidance of the transfers made by the Debtor to the Co-Debtor and her corporation.[1] The trial of the Plaintiff's suit was scheduled to start on September 17, 2001.

On July 16, 2001, the Debtor's father, Donald Tinney, as Trustee under a land trust, executed

[1]The Plaintiff attacked the transfers as fraudulent conveyances under state law.

four mortgages on real estate known as 815 North Church Street, Belleville, Illinois. One mortgage ran to the Debtor's parents, Donald and Marie Tinney (jointly referred to as "Tinneys") (Def. Ex. 2-7). The note secured by this mortgage was given earlier, on June 5, 2001, in the amount of $8,000, when the Tinneys issued a check for $7,972 to attorney Thomas A. Lechien to pay attorney fees incurred on Debtor's behalf (Def. Ex. 2-1).

Another mortgage ran to the Tinneys. This mortgage (Def. Ex. 2-8) secured two promissory notes dated the same date as the mortgage. One promissory note was in the amount of $64,694.46, signed by the Debtors (Def. Ex. 2-2). The second promissory note was in the amount of $51,775.28 and was signed by the Debtors and the Co-Debtor's corporation (Def. Ex. 2-3).

Two mortgages ran to the Co-Debtor's parents, Ron and Jean Speiser (jointly referred to as "Speisers"). The first of these two mortgages (Def. Ex. 2-10) secured a note in the amount of $10,000, executed seven days earlier on July 9, 2001, to evidence a check issued by the Speisers on July 9, 2001, to acquire a cashier's check payable to Attorney Jay Huetsch to retain him to represent the Debtor (Def. Ex. 2-4).

The second of the two mortgages (Def. Ex. 2-11) secured two notes dated the same date as the date of the mortgage. One note was in the amount of $18,877.56 and was signed by the Debtors (Def. Ex. 2-5). The second note was in the amount of $12,350.30 and was signed by the Debtors and the Co-Debtor's corporation (Def. Ex. 2-6). Both notes evidenced transfers to the Debtors and the Co-Debtor's corporation.

On March 19, 2003, the state court entered judgment in favor of the Plaintiff for $262,107.26 due under the lease agreement (modified August 5, 2003). The state court found that the Debtor's 1996 transfer of assets to the Co-Debtor and her corporation constituted a fraudulent conveyance.

On September 4, 2003, the Debtors filed a Chapter 13 bankruptcy petition. Their bankruptcy schedules indicate that the Plaintiff is their only unsecured creditor. Their bankruptcy schedules further indicate that in the absence of the four mortgages to the Debtors' parents, there would be approximately $87,000 in equity in the real property.

The Plaintiff then filed this two count adversary proceeding, Count I against the Tinneys and Count II against the Speisers, which counts are identical in the relief sought, to have the claims of the Tinneys and the Speisers denied and to have the purported liens in favor of the Tinneys and the Speisers determined to be invalid.[2]

The Plaintiff argues that the transfers of funds made by the Tinneys and the Speisers to the Debtors during the period of 1992 though 2001 were gifts, not loans. Thus, Plaintiff argues, their secured claims must be denied.[3] In the alternative, Plaintiff argues, even if the transfers of funds to the Debtors were loans, they were unsecured prior to the July 16, 2001 grants of mortgages. Thus, the grants of mortgages were fraudulent conveyances and accordingly, the claims of the Tinneys and the Speisers should be equitably subordinated.

The Tinneys and the Speisers argue that the evidence is clear and convincing that the transfer of funds by them to the Debtors were loans. Accordingly, they argue, they had the right to secure these loans by the mortgages.

The issues before the Court in this adversary proceeding are:

1. Are the transfers of funds by the Tinneys and the Speisers to the Debtors gifts or loans?

2. If loans, should the loans be equitably subordinated pursuant to § 510 of the Bankruptcy Code, 11 U.S.C. § 510?

This Court will first consider whether the transfers of funds by the Tinneys and the Speisers to the Debtors are gifts or loans. A case instructive in determining whether monetary transfers by

[2]As of the date of the trial of the adversary proceeding, neither the Tinneys or the Speisers had filed a proof of claim in the Debtors' Chapter 13 case.

[3]Thereby freeing assets to pay the Plaintiff's claim.

a parent to a child are gifts or loans is *In re Marriage of Schmidt*, 242 Ill.App.3d 961 (4th Dist. 1993). In *Schmidt*, the court considered three categories of transfers from the parents to their son Robert and his wife Lynn. *Id.* at 696. These categories were: (1) money transferred as gifts on special occasions, (2) alleged loans where notes were obtained at the time the transfer was made, and (3) alleged loans where no notes were obtained until after Robert's and Lynn's separation. *Id.* The court found that the transfers made as gifts on special occasions were indisputably gifts. *Id.* Further, the court found that the transfers in category (3), despite Robert and his parents labeling them as loans, were also gifts. *Id.* The court stated that the notes, "which were not signed contemporaneously with the transfers, but signed only by Robert after the parties' separation, was suspicious...." *Id.* Although the court found that the notes in category (2) had the best chance for being considered a loan, it stated that "there was evidence upon which the [trial] court could have based a finding that what appeared to be loans were actually gifts to the marriage." *Id.* The court arrived at this finding by considering Lynn's testimony that "the notes were never intended to be repaid, and set out no interest rate at the time she signed them." *Id.* at 969-70. Further, the court found it relevant that "[t]here was no evidence of any payments ever being made on the notes, either of interest or principal." *Id.* at 970. The court stated that the findings discussed *supra* "would not be contrary to the manifest weight of the evidence" because:

> Trial courts are rightly skeptical of transfers by the parents of one of the litigants in a dissolution case. There is an incentive for both sides of the transfer, the parents making it and the litigant receiving it, to conform their testimony to the disadvantage of the other litigant. Transfer where the parents would never have sought repayment, if the marriage had remained intact, may be viewed from a different perspective when the marriage falls apart.

Id. at 968.

The analysis in *Schmidt* can be helpful in addressing the issue involving the transfers of funds the Tinneys and the Speisers made to the Debtors. As a preliminary matter, the Plaintiff is correct in pointing out that there is a presumption in Illinois that all the transfers of funds by the Tinneys and the Speisers to the Debtors are gifts. In order to overcome this presumption, under Illinois law, the Tinneys and the Speisers must present "clear and convincing evidence" that the transfers were loans and not gifts. *In re Marriage of Didier*, 318 Ill.App.3d 253, 258 (1st Dist. 2000) (quoting *In re Marriage of Hagshenas*, 234 Ill.App.3d 178, 186 (1992)).

The note to the Tinneys dated June 5, 2001, (Def. Ex. 2-1) and the mortgage dated July 16, 2001, (Def. Ex. 2-7) evidences a loan, not a gift. This transfer of $8,000 was made shortly after the Debtor's then attorney sent a statement for legal services rendered in the state court action (Def. Ex. 1-6). The transfer was for approximately the amount of the statement. It is payable on demand and provides for interest and is signed by both Debtors.

The note to the Speisers dated July 9, 2001, (Def. Ex. 2-4) and the mortgage dated July 16, 2001, (Def. Ex. 2-10) likewise evidences a loan, not a gift. This transfer of $10,000 was made on behalf of the Debtor, direct to the Debtor's new attorney to represent the Debtor in the state court litigation (Def. Ex. 4-2). It too is payable on demand and provides for interest and is signed by both Debtors.

The two promissory notes to the Tinneys dated July 16, 2001, in the amounts of $64,694.46 and $51,775.28 (Def. Ex. 2-2 and 2-3) and the mortgage securing them (Def. Ex. 2-8) evidence gifts, not loans. These two promissory notes were not taken at the time of the transfers of funds. The transfers of funds started approximately 9-10 years before the notes were taken without any writing to indicate when they were to be repaid, what interest was to be paid, or obligating the Debtors to pay anything. They were for a variety of uses and in varying amounts. Some were for as little as $5, numerous transfers were for approximately $15, $20, $25, $35. They were for items normally associated with gifts, for example, Christmas presents, groceries, gas, church pictures, shoes, zoo trip or bikes. Transfers of funds which most parents would not expect to be repaid. These types of transfers over a long period of time taint the others made during that period. Furthermore, the Debtors signed nothing agreeing to repay the transfers of funds or to pay interest until the two notes and mortgage were given when the state court litigation was going to trial. While there was some repayment by the Debtors to the Tinneys, it was sporadic and insignificant compared to the amounts transferred to the Debtors. Mrs. Tinney testified the transfers were to be repaid when the Debtors could repay. Such an indefinite condition creates doubt as to whether repayment would ever be required or made.

The same result is applicable to the two notes to the Speisers dated July 16, 2001, for $18,877.56 and $12,350.30 (Def. Ex. 2-5 and 2-6) and the mortgage securing them (Def. Ex. 2-11). These transfers of funds also go back approximately 9 years without any writing to indicate when they were to be repaid, what interest was to be paid, or obligating the Debtors to repay anything. Some were for as little as $15, $20 or $25. Some were for Christmas presents for kids, birthdays, gas, church picnic, or kid's haircuts or field trip. Just as with the transfers of funds by the Tinneys, these were transfers for which most parents would not expect to be repaid and taint the others made during that period. When the notes and mortgage were finally taken, they too were taken when the state court litigation was going to trial. Finally, there was no proof of any significant repayments over the 9 years until January and February of 2003.

It is a basic principle of mortgage law that in order to have a valid mortgage there must be a valid and enforceable debt underlying the mortgage. As two of the notes given to the Tinneys and two of the notes given to the Speisers do not evidence debts, but gifts, there is no underlying debt which two of the mortgages can secure. So those two mortgages (Def. Ex. 2-8 and 2-11) are unenforceable.

The last issue before the Court is whether under § 510 of the Bankruptcy Code the loans to the Debtors by the Tinneys and the Speisers should be equitably subordinated. As this Court has held that only two of the notes evidenced loans and the others evidenced gifts, the equitable subordination argument is relevant only as to the two notes evidencing loans.

Section 510(c) of the Bankruptcy Code, 11 U.S.C. § 510(c), provides that "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...." Thus, under this section, claims can be subordinated under principles of fairness or on equitable grounds.

The Seventh Circuit, in *Matter of Lifschultz Fast Freight*, 132 F.3d 339, 344 (7th Cir. 1997), followed the following three-factor test established in *Mobile Steel Co.*, 563 F.2d 692, 700 (5th Cir. 1977), for determining whether equitable subordination is proper:

> One, "[t]he claimant must have engaged in some type of inequitable conduct." (Citation omitted). Two, "[t]he misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant." (Citation omitted). And three, "[e]quitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy [Code]." (Citation omitted).

It is also important to note that "[t]he legal standard in applying this test varies depending on whether the creditor is an insider or a non-insider." *In re Baker & Getty Financial Services, Inc.*, 974 F.2d 712, 718 (6th Cir. 1992). The Sixth Circuit further indicated that:

> The primary distinctions between subordinating the claims of insiders versus those of non-insiders lie in the severity of the misconduct required to be shown, and the degree to which the court will scrutinize the claimant's actions toward the debtor or its creditors. Where the claimant is a non-insider, egregious conduct must be proven with particularity. It is insufficient for the objectant in such cases merely to establish sharp dealing; rather, he must prove that the claimant is guilty of gross misconduct tantamount to "fraud, overreaching or spoliation to the detriment of others." Where the claimant is an insider, his dealings with the debtor will be subjected to more exacting scrutiny.

Id. (Citing *Matter of Teltronics Services, Inc.*, 29 B.R. 169 (Bankr.E.D.N.Y. 1983).

As the *Lifschultz Fast Freight* court noted, this analysis first requires a determination of whether there was inequitable conduct. *Matter of Lifschultz Fast Freight*, 132 F.3d at 344. The court noted that "[i]n the context of equitable subordination, the type of conduct that has been considered 'inequitable' generally falls within the following categories: '(1) fraud, illegality, breach of fiduciary duties; (2) undercapitalization; and (3) claimant's use of the debtor as a mere instrumentality or alter ego.'" *Id.* at 344-45 (citing *Matter of Missionary Baptist Foundation of America, Inc.*, 712 F.2d 206, 212 (5th Cir. 1983)).

In this case, the Plaintiff alleges that "[t]he inequitable conduct...on the part of the Debtors' parents is their taking of promissory notes and mortgages from the Debtors in the midst of the state court fraudulent [conveyance] litigation over Debtors' 1996 transactions, where such notes and mortgages related to transactions occurring years earlier." Plaintiff's Brief at 12-13. Specifically, the Plaintiff argues that the Debtors' parents wrongful acceptance/request that they be granted the mortgages and their subsequent act of recording the mortgages "immediately prior to trial" made their conduct especially inequitable. The Debtors' parents, on the other hand, argue that their conduct was not inequitable because there was a dispute as to whether any debt was actually owed to the Plaintiff. Furthermore, they argue that any lender in the same circumstance would have similarly requested collateral.

It is also important to note, in light of the fact that Debtors' parents are "insiders" as defined by § 101 of the Bankruptcy Code, 11 U.S.C. § 101(31), that if Debtors' parents are indeed considered "insiders" in the context of this litigation, that their conduct will be "subjected to more exacting scrutiny." However, insider status alone is insufficient to justify equitable subordination of an insider's claim. *In re Vermont Elec. Generation & Transmission Co-op., Inc.*, 240 B.R. 476 (Bankr.D.Vt. 1999).

Applying the standards in *Lifschultz Fast Freight* to the facts in this case, this Court cannot conclude that the Tinneys or the Speisers acted in an inequitable manner as to the two notes they took to evidence loans to the Debtors. These notes do not involve "under capitalization" or the using of the Debtors as a "mere instrumentality" or "alter ego." Nor was there any "fraud, illegality, or breach of fiduciary duty" associated with them. The Tinneys and the Speisers loaned the Debtors substantial sums of money to fund the state court litigation and took the two notes to evidence those loans and the mortgages to secure them.

###

ENTERED: June 8, 2005

/s/ William V. Altenberger
UNITED STATES BANKRUPTCY JUDGE