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IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF UTAH

Central Division

In re STEPHEN M. HARMSEN, Debtor.	Bankruptcy No. 03-33637 JAB (Involuntary Chapter 7) **TRIAL BRIEF**

The Society of Lloyd's ("**Lloyd's**"), hereby submits its pretrial Brief.

INTRODUCTION AND SUMMARY OF ARGUMENT

This involuntary case was commenced by Lloyd's on August 9, 2003, in response to the Debtor's fraudulent attempts to thwart Lloyd's efforts to collect a federal judgment in the amount of £229,401.82 (approximately $418,952.00 as of this trial date). Debtor claims that all of his non-exempt personal property was seized and sold in June of 2003 at execution sale by West American Finance Co. ("**WAFCO**"), a family owned business managed and controlled by the Debtor himself. The alleged execution sale allegedly partially satisfied a judgment consentually entered against the Debtor and in favor of WAFCO in 1996 (after Lloyd's began legal action

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against the Debtor in the courts of England). Prior to the execution sale, the Debtor claimed to have assets worth $4,070,923.00 and a net worth of $1,771,426.00 (even taking into account $2,215,907.00 claimed to be owed to WAFCO pursuant to the judgment).

Prior to the Involuntary Petition commencing this case, Lloyd's propounded written interrogatories on Stephen Harmsen demanding to know what assets and liabilities he had. Mr. Harmsen's responses showed that he had fewer than twelve creditors eligible to be counted under § 303(b)(2) of the Bankruptcy Code. Therefore, Lloyd's filed this Petition as the sole petitioning creditor.

The primary thrust of the Debtor's defense to Lloyd's Petition is that he had as of the Petition Date, and still has, twelve or more creditors which qualify to be counted under § 303(b)(2). Failing that, the Debtor alleges that he was, as of the Petition Date, generally paying his debts as they came due (despite the loss of all of his non-exempt assets at execution sale two months earlier).

No more than seven of the 23 creditors listed by the Debtor in his answer to the Involuntary Petition are eligible to be counted under § 303(b)(2). The majority of the listed creditors are either (1) insiders, (2) the holders of disputed or contingent claims, (3) the recipients of avoidable preferences, post-petition payments or fraudulent conveyances, (4) insufficiently identified under Rule 1003 of the Bankruptcy Rules, (5) were not disclosed to Lloyd's by September 24, 2003, as ordered by the Court (6) are *de minimus*; or (7) the Debtor has expressly waived his right to count the creditor under § 303(b)(2).

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The burden of going forward and of persuasion is allocated between Lloyd's and the Debtor as follows: Lloyd's must prove by a preponderance of evidence that it is a creditor and that at the time of the Petition, the Debtor was not generally paying its debts as they became due. The Debtor must prove, on the other hand, that he has more than eleven creditors qualified to be counted under § 303(b)(2). *See In re Rothery*, 143 F.3d 546, 549 (9th Cir. 1998) (debtor has burden to prove number of qualifying creditors in opposition to an involuntary petition in bankruptcy); *In re Rimell*, 111 B.R. 240 (Bankr. E.D. Mo. 1990) (involuntary debtor has burden of proof as to number of qualified creditors). To the extent the eligibility of any creditor is challenged by Lloyd's, it is Lloyd's burden to present a prima facie case for disqualification (*e.g.*, the receipt of an apparently avoidable transfer either pre- or post-petition) but the burden of persuasion pertaining to the eligibility issue remains with the Debtor. *Id.*

ARGUMENT

POINT I

BANKRUPTCY RULE 1003 REQUIRES THAT THE INVOLUNTARY DEBTOR GIVE MORE INFORMATION REGARDING HIS ALLEGED CREDITORS THAN MERELY THE CREDITOR'S NAME

Bankruptcy Rule 1003 provides, in pertinent part, as follows:

> (b) *Joinder of Petitioners After Filing*. If the answer to an involuntary petition filed by fewer than three creditors avers the existence of twelve or more creditors, the debtor shall file with the answer a list of all creditors with their addresses, a brief statement of the nature of their claims, and the amounts thereof. If it appears that there are twelve or more creditors as provided in § 303(b) of the Code, the court shall afford a reasonable opportunity for other creditors to join in the petition before a hearing is held thereon.

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Rather than comply with the Rule, the Debtor filed a Motion to Dismiss to which are attached a credit report and an affidavit listing more than 50 creditors by name only. In response, Lloyd's filed a Request for Production of Documents demanding documentary evidence of each of the claims claimed by the Debtor and obtained a court order requiring the Debtor to respond by September 24, 2003. *See* Order dated September 10, 2003. Eventually the Debtor withdrew his Motion and filed an Answer in which a different set of alleged creditors is listed (totaling 33). Few of the originally listed creditors (less than half) are also claimed as creditors in the Debtor's Answer. Many of the newly listed alleged creditors were not included in the Debtor's responses to this Court's Order requiring the Debtor to provide documentary proof (on or before September 24, 2003) of the identity and amount of any creditors the Debtor claimed to have as of the Petition Date. Even now, the Debtor has failed to fully comply with Rule 1003 and state the amount owed as of the Petition Date for several of the creditors listed in his Answer (*i.e.*, H.J. & Associates, Washington Mutual, Western Farm Credit Bank, The Names Legal Committee, Zions Investment Securities, California National Bank, Utah Jazz and San Diego Gas & Electric Co.). As such, none of these so-called creditors should be counted toward the twelve that the Debtor must have to defeat Lloyd's Involuntary Petition.

POINT II

NOT ALL CREDITORS QUALIFY TO BE COUNTED AMONG THE TWELVE NECESSARY TO DEFEAT THE INVOLUNTARY PETITION

11 U.S.C. § 303(b)(2) excludes, for counting purposes, any creditors who are (1) insiders, (2) hold a contingent or disputed claim or (3) who have received money they will be required to

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disgorge under one or more of the trustee's avoiding powers if the bankruptcy proceeds (*e.g.*, §§ 544, 547, 548 or 549). The evidence at trial will show that almost all of the creditors Debtor claims to have fall within one or more of these categories.

Without going into detail as to each claim, the following legal points will likely be relevant in determining which of the claims may qualify:

A. Whether a claim is "disputed" is to be determined as of the Petition Date and subsequent payment of the claim by the Debtor is irrelevant. *Bartholomew v. Maverick Tube Corp.*, 853 F.2d 1540, 1544 (10th Cir. 1981).

B. Creditors who qualify as of the Petition Date cease to qualify upon receipt of post-petition payments from the Debtor because such payments are recoverable under § 549(a)(2). *In re Garland Coal & Mining*, 67 B.R. 514, 519 (Bankr. W.D. Ark. 1986).

C. The Debtor has the burden of proving the validity (non-avoidability) of any post-petition transfer under § 549. *In re Rimell*, 111 B.R. 250, 256 (Bankr. E.D. Mo. 1990) (debtor has burden to prove post-petition payments to creditors are not recoverable under § 549 in order to defeat involuntary petition). *See* Bankruptcy Rule 6001 ("Any entity asserting the validity of a transfer under § 548 of the Code shall have the burden of proof.")

D. A debt incurred by the Debtor for utility services provided to real estate not owned by the Debtor at a time when the Debtor was insolvent is avoidable as a fraudulent conveyance under § 548(a)(B) ("Trustee may avoid . . . or any obligation incurred by the debtor . . . .".)

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E. Once Lloyd's has established a *prima facie* case of avoidability under § 547(b), it is the burden of the Debtor to show the non-avoidability of the transfer under § 547(c). *In re Rothery, supra.*

F. Where a claim is fully secured by real estate not owned by the Debtor, any claim against the Debtor as the obligor under a secured promissory note is "contingent" or "disputed" by virtue of applicable one action rules and anti-deficiency statutes. (*See* discussion below.)

G. Debts incurred by the Debtor to health care professionals for services provided to emancipated adult children are avoidable as fraudulent under § 548(a)(B).

H. A Debtor may waive his right to contest an involuntary petition based on the number of his creditors. *In re Mason*, 20 B.R. 650 (9th Cir. BAP); aff'd, 709 F.2d 1313; *In re Kidwell*, 158 B.R. 203 (Bankr. E.D. Cal. 1993 (the change of numbers of petitioning creditors is substantive, not jurisdictional, defense). Where a debtor, in fact, has more than twelve creditors but fails to comply with applicable rules, or Court orders regarding disclosure and discovery or has affirmatively stated that he will not count certain creditors toward the twelve in response to complaints by the petitioning creditor that he has not provided adequate information regarding those creditors, the debtor may enter an order of relief despite the actual number of creditors the debtor might have. *Id.*

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POINT III

KELLY HARMSEN'S OVERDRAFT ACCOUNT AT KEY BANK IS NOT AN OBLIGATION OF STEPHEN HARMSEN

Mr. Stephen Harmsen seems to assert in his Answer that his wife's overdraft at Key Bank is also his obligation. No evidence has been provided by the Debtor that he is a signatory or otherwise obligated on the overdrafted account. *See In re Rimell*, 111 B.R. 250, 252 (Bankr. E.D. Mo. 1990) (wife is not debtor under Sears account in name of husband even though wife allowed to purchase merchandise under the account).

POINT IV

CREDITORS WHO HAVE RECEIVED TRANSFERS RECOVERABLE UNDER §§ 547 OR 549 OR WHO HAVE CONTINGENT OR DISPUTED CLAIMS ARE NOT QUALIFIED TO BE COUNTED

Section 303(b)(2) provides:

> An involuntary case against a person is commenced by the filing with the Bankruptcy Court of a petition under Chapter 7 or 11 of this Title—
>
> > (1) by three or more entities, each of which is either a holder of a claim against such person that is not contingent as to liability or the subject of a bona fide dispute, or an indenture trustee representing such a holder, if such claims aggregate at least $11,625.00 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims;
> >
> > (2) if there are fewer than twelve such holders, excluding any employee or insider of such person and any transferee of a transfer that is voidable under § 544, 545, 547, 548, 549, or 724(a)

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> of this Title, by one or more of such holders that hold in the aggregate at least $11,625.00 of such claims.

Under the plain language of § 303(b)(2), holders of contingent or disputed claims or insiders of the debtor or claimholders who have received voidable transfers either before or after the petition date are not counted in determining whether the debtor has twelve or more creditors. The evidence at trial will be undisputed that of the creditors claimed by the Debtor Steven Wuthrich, the Alta Club, Dr. Liddell, Dr. Call, Steven Lybbert, the Newspaper Agency Corporation, Washington Mutual Home Loan, the Names Legal Committee, F. Wexler Co., Key Bank, Comcast, Salt Lake City Corp., Questar Gas, Utah Power, Dr. Summerhays, Silkies, Melenaiti Vi, Bank of America, MBNA, American Express, Capital One, Salt Lake City Credit Union and the Utah Jazz have all received payments on their pre-petition claims after the Petition Date or are holders of claims disputed by the Debtor. Thus, none of those creditors may be counted under § 303(b)(2). *In re Rimell, supra*, at 256.

Section 549 of the Bankruptcy Code provides as follows:

> A. Except as provided in subsections (b) or (c) of this section, the trustee may avoid a transfer of property of the estate—
>
> (1) that occurs after the commencement of the case; and
>
> (2)(a) that is authorized only under § 303(f) or § 542(c) of this Title; or
>
> (b) that is not authorized under this Title by the Court.

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> B. In an involuntary case, the trustee may not avoid under subsection (a) of this section a transfer made after the commencement of such case but before the order for relief to the extent any value, including services, but not including satisfaction or securing of a debt that arose before the commencement of the case, is given after the commencement of the case in exchange for such transfer, notwithstanding any notice or knowledge of the case that the transferee has.

(Emphasis added.)

Payments made to creditors after the involuntary petition is filed are subject to being set aside pursuant to 11 U.S.C. § 549 as unauthorized payments of pre-petition unsecured debts. And the creditors receiving such payments may not be counted under § 303. *See In re Garland Coal & Mining Co.*, 67 B.R. 514, 519 (Bankr. W.D. Ark. 1986) (even though involuntary debtor listed 66 creditors, all were paid in full or on account either before or after the petition and none qualified to be counted under § 303).

POINT V

THE CLAIMS OF THE LENDERS FULLY SECURED BY REAL ESTATE NOT OWNED BY THE DEBTOR ARE CONTINGENT AND SUBJECT TO BONA FIDE DISPUTE UNDER APPLICABLE STATE LAW AND THEREFORE MAY NOT BE COUNTED UNDER § 303

The alleged unsecured claim of Federal Land Bank is based upon a promissory note signed by the Debtor which is secured by property, with a value admitted to be more than the debt, located in Nevada and owned by a third party. While the Debtor seems to assert that this claim is noncontingent and not subject to a bona fide dispute, the Debtor fails to appreciate the effect of Nevada law which dictates otherwise.

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Like many western states (including Utah), Nevada has legislation which makes the liability of an obligor under a note secured by a mortgage or trust deed on real property contingent upon foreclosure and the existence of a deficiency. Nev. Rev. Stat. §§ 40.430 (one action rule); 40.455 (anti-deficiency rules for trust deed foreclosures). Under these statutes an obligor has no liability, and no judgment for personal liability may issue, until the property is sold as part of a foreclosure action (or, in the case of a foreclosure under a trust deed, the property is sold and a timely deficiency action is brought and a determination is made that the fair market value of the property was less than the amount of the obligation). *See, e.g., Component System Corp. v. Eighth Judicial District Court*, 692 P.2d 1296 (Nev. 1985) (creditor had no claim for a personal judgment because at the time of serving the complaint, the creditor had not sold the property).

The one-action rule and anti-deficiency legislation effectively amend any note secured by real property by legislative fiat to incorporate a covenant that there will be no personal liability until after default and foreclosure and then only if foreclosure fails to satisfy the debt. This security-first requirement effectively transforms an otherwise noncontingent personal liability under a note into a contingent one where the obligor's personal liability is secondary to the primary obligation borne by the property. The debt owing by the obligor is, thus, analogous to that of a guarantor who has guaranteed an obligation conditioned upon the creditor having exhausted collection efforts against the primary obligor (*i.e.*, a collection guaranty). Under the bankruptcy vernacular, such a debt is "contingent." *See In re Pennypacker*, 115 B.R. 504 (Bankr.

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W.D.N.Y. 1980) (describing a "classic example" of a "contingent debt" for purposes of determining chapter 13 eligibility as a guaranty obligation which requires default of the principal).

Not only is Federal Land Bank's claim contingent as a matter of the Nevada law discussed above, it is further subject to a bona fide dispute based upon the undisputed facts. Assuming relief under this Petition were granted and Federal Land Bank was to file a proof of unsecured claim, it would represent a contingent debt which would need to be estimated for purposes of distribution based on a projected deficiency. *See* 11 U.S.C. § 502(c). Where it is undisputed that the property has a value of more than the debt, there is little doubt that the Debtor would dispute and object to the allowance of any claim whatsoever. There is also little question that the Debtor would be successful in prosecuting such an objection. Nevertheless, to avoid the granting of relief, the Debtor is asserting at this time that Federal Land Bank has a valid claim and that it is undisputed. However, the lack of a deficiency upon which to base any assertion to a "right to payment"[1] shows that the Debtor's assertion is self-servingly unfounded. Because there is no deficiency, there is no right to payment; and any claim asserted by Federal Land Bank is subject to an absolute defense and, at the very least, a bona fide dispute.[2]

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[1]"Claim" is defined as a "*right to payment*, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(5).

[2]Because it is in the Debtor's interest not to dispute [name's] claim, the claim is not subject to a bona fide dispute by the Debtor. Section 303 does indicate, however, that the bona fide dispute may only be raised by the Debtor. Lloyds is granted the statutory right to object to any claim asserted by any creditor and similarly asserts its rights to assert a bona fide dispute where the Debtor has failed to do so. *See* 11 U.S.C. § 502(a) (allowing any party in interest to object to claims).

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Similarly, the Debtor's obligations to California National Bank and Washington Mutual Bank are contingent because those claims are also fully secured by real estate located in California or Utah. As an obligor under the fully secured notes, the Debtor is protected from personal liability under both Utah's and California's anti-deficiency statutes. Pursuant to the one-action rules of California and Utah, these creditors' "right to payment" from, and claim against, the Harmsens is contingent upon exhaustion of the security. *Utah Law:* UTAH CODE ANN. § 78-37-1 (one-action rule); *Bank or Ephraim v. Davis*, 581 P.2d 1001, 1003 (Utah 1978) (until the security is exhausted "the creditor is not yet in a position to obtain personal judgment against the debtor."); *First Security Bank v. Felger*, 658 F. Supp. 175 (D. Utah 1987) (one-action rule applies to trust deeds). *California Law:* Cal. Code Civ. Pro. § 726 (one-action rule); § 725a (one-action rule applicable to trust deeds); *Birman v. Loeb*, 64 Cal. App. 4th 502, 512, 75 Cal. Rptr. 2d 294, 300 (Cal. App. 1998) ("In California, a creditor's right to enforce a debt secured by a trust deed on real property is restricted by statute . . . 'the creditor must rely upon his security before enforcing the debt.'") (citations omitted). Moreover, even if the contingency were overlooked, Washington Mutual's claim against the Harmsens for any deficiency would be subject to a bona fide dispute because the properties are admittedly worth more than the debts. Under such facts, the anti-deficiency legislation of Utah and California provide a complete defense to any deficiency claim and, at the very least, make the contingent debt also subject to a bona fide dispute. *See* UTAH CODE ANN. § 57-1-32; Cal. Code Civ. Pro. § 580a *et seq.*

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POINT VI

MR. WUTHRICH, ESQ., IS AN "INSIDER" OF THE DEBTOR AND THEREFORE DOES NOT QUALIFY TO BE COUNTED

The definition of an "insider" under § 101(31) is flexible and has been described as a person or entity with "a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor." S. Rep. No. 95-989, 95th Cong., 2d Sess., reprinted in 1978 U.S. Code Cong. & Admin. News, pp. 5787, 5810. Mr. Wuthrich presently represents the Debtor in her appeal before the Tenth Circuit of Judge Campbell's Judgment and has advised the Debtor to contest the Involuntary Petition commencing this case. As such, Mr. Wuthrich is precluded by his duties to the Debtor from participating with Lloyd's as a petitioning creditor in this case and therefore should be disqualified to be counted as a creditor under § 303. This was done by the Bankruptcy Court in *In re Rimell, supra*, at 254 (attorneys presently representing involuntary debtor excluded under § 303(b)(2) as insiders although former attorneys whose services are not related to the case may be counted).

POINT VII

AS OF THE PETITION DATE THE DEBTOR HAD NOT BEEN PAYING HIS DEBTS AS THEY BECAME DUE

In determining whether a debtor is not generally paying its debts as they come due courts generally look at four broad factors: (1) the number of debts, (2) the amount of the delinquencies, (3) the materiality of a nonpayment, and (4) the nature of the alleged debtor's financial affairs.

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In re Norris, 183 B.R. 437 (Bankr. W.D. La. 1995). The foregoing sentence is virtually a quote of a portion of the Debtor's Memorandum in support of his original Motion to Dismiss. Lloyd's and the Debtor apparently agree on what the law is but not on its application in this case.

In considering the four factors suggested by the Court in *In re Norris*, 183 B.R. 437 (Bankr. W.D. La. 1995), Lloyd's respectfully suggests that the number of the Debtor's total debts are few and therefore the two creditors (Lloyd's and WAFCO), which have not been paid on a timely basis, are a significant number, particularly in light of the amount of the total delinquency (over $2 million), and that the nonpayment of these debts is very material.

This is not the "single creditor case" described in the case of *In re James A. Norris, supra*, relied upon by Debtor in his original Motion to Dismiss. Even if Lloyd's were the Debtor's only creditor as of the date of the Involuntary Petition, this case comes well within the two "well-recognized exceptions to the general rule" that involuntary relief will be granted to a single creditor where either:

> 1. Special circumstances amounting to trick, fraud, artifice or scam were used to isolate the creditor, or
>
> 2. The creditor cannot possibly obtain adequate relief outside the bankruptcy setting.

Norris, at 460.

This case is similar to the case of *Concrete Pumping Services, Inc. v. King Construction Co.*, 943 F.2d 627 (6th Cir. 1991) discussed in *Norris* at p. 460. In *Concrete Pumping*, after the debtor lost a judgment to the creditor an insider executed upon almost all of the debtor's assets

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pursuant to a security agreement and then quickly opened another business similar to that of the debtor, thus isolating the disfavored creditor through means which smacked of "fraud, artifice, scam, or possibly all three." *Id.* at 460.

In the present case, the Debtor, in collusion with WAFCO (a family controlled business) has attempted to isolate Lloyd's through a collusive judgment execution sale which has had little, if any, practical effect on the Debtor. The judgment WAFCO holds was purchased from another creditor and is against not only the Debtor in this case but other companies owned or controlled by the Debtor as well. The Harmsen family has not executed on this judgment for over six years and rather than take any action against any of the companies has, in a sham fashion, asserted that it has executed on all of the nonexempt assets of Mr. and Mrs. Harmsen personally. It is worth noting that the judgment was apparently purchased by WAFCO shortly after Lloyd's began its lawsuit against the Harmsens in England. Mr. Harmsen still serves as WAFCO's manager of day-to-day business affairs and as registered agent.

POINT VIII

THE DEBTOR'S *DE MINIMUS* CLAIMS SHOULD NOT BE COUNTED

Among the claims asserted by Mr. Harmsen to have existed on August 9, 2003, are Time Warner Cable ($11.77), Dr. Call ($15.00), Simper Energy Utility ($56.35), F. Wixler Co. ($20.40), Silkies ($13.96), Questar Gas ($63.49) and Comcast ($89.40). Whether such small claims should be counted under § 303(b) has not yet been ruled upon by the Tenth Circuit and there is a split of authority among the Courts that have decided the issue. *See In re Hoover*, 32

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B.R. 842, 846-847 (Bankr. Okla. 1983) (describing a split of authority and noting that some courts have found the presence of a scheme to inflate the number of creditors sufficient grounds to exclude *de minimus* claims). Thus far the Fifth Circuit in the case of *Denham v. Shellman Grain Elevator, Inc.*, 444 F.2d 1376 (5th Cir. 1971), appears to be the leading case excluding such claims. The Seventh Circuit, Ninth Circuit and Six Circuit BAP have determined that even small claims should be included. *Matter of Rassi*, 701 F.2d 637 (7th Cir. 1983); *In re Okamoto*, 491 F.2d 496 (9th Cir. 1974); *In re Eastown Auto Co.*, 215 B.R. 960 (6th Cir. BAP 1998).

In this case, the evidence at trial will show that Mr. Harmsen has resorted to desperate measures in order to increase the number of qualifying creditors in his case and in his wife's case, including eliciting fabricated billings from some of his creditors. The claim of Silkies, for example, was originally admitted to be disputed by Mr. Harmsen but, after realizing the importance of the claim, he has apparently changed his mind. If such small claims are to be allowed, it seems a ripe area for manipulation of the bankruptcy process by debtors who wish to engage in fraudulent activity and at the same time avoid a trustee's strong-arm powers, such as this case presents. It is relatively simple for a debtor to create a great number of small (and therefore ambivalent) creditors. Mr. Harmsen admitted, for example, in his deposition that Dr. Call (owed $15.00) has said that he did not care when he got paid. The Court should exclude such claims from a § 303(b)(2) count.

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CONCLUSION

Lloyd's shall explain in detail in its proposed Findings of Fact and Conclusions of Law, when filed, how the forgoing principles apply to each of the Debtor's alleged creditors listed in the Debtor's Answer.

DATED this 24th day of February, 2004.

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CERTIFICATE OF SERVICE

I hereby certify that on the 24th day of February, 2004, I served the foregoing by causing a true and correct copy thereof to be hand delivered to the following:

Mona L. Burton, Esq.
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