

ORDERED.



Dated: December 22, 2008

Eileen W. Hollowell

EILEEN W. HOLLOWELL
U.S. Bankruptcy Judge

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF ARIZONA

In re

DAVID H. POLSKY and
PATRICIA S. POLSKY,

Debtors.

Chapter 11

Case No. 4-05-bk-07805-EWH

TOM PETERSON, as Trustee to the
Thomas M. Peterson Trust,

Plaintiff,

Adversary No. 4-08-ap-00393-EWH

v.

DAVID H. POLSKY and
PATRICIA S. POLSKY,

Defendants.

MEMORANDUM DECISION

I. INTRODUCTION

The Debtors assert certain counterclaims which arose out of an agreement with a potential investor. Because the claims the Debtors seek to enforce belong to their wholly-owned limited liability company and not to them, those claims, even if valid, cannot be applied to offset claims asserted against the Debtors by the investor's trust. The reasons for the Court's conclusions are explained in the balance of this decision.

1 **II. FACTS**

2 Prepetition, the Debtors were the sole members of a limited liability company,
3 Jarco Automotive ("Jarco"), which operated a car repair business known as Dave
4 Polsky Automotive ("Polsky Automotive") where both Debtors worked. Tom Peterson
5 ("Peterson") took one of his cars to Polsky Automotive for major repairs. He was very
6 satisfied with the work done on his car and thereafter regularly took his cars to Polsky
7 Automotive for service. Over time, Mr. Peterson developed a cordial relationship with
8 the Debtors.
9

10 In late 2000, David Polsky approached Peterson about making a \$50,000
11 investment in a second car repair shop to be known as Goodyear of Green Valley
12 ("GOGV"). Debtors planned to operate GOGV through A & J Parts Unlimited ("A&J"),
13 another limited liability company solely owned by the Debtors.
14

15 On January 1, 2001, the Debtors, in their individual capacities, and Peterson, in
16 his individual capacity, and A&J, through the Debtors as its members, entered into an
17 agreement ("Investment Agreement") regarding Peterson's proposed investment. The
18 Investment Agreement provided for Peterson to invest \$50,000 in A&J dba GOGV.
19 Peterson was to receive an 11.5% return on his investment over ten years to be
20 secured by 2% of A&J's available stock. Peterson was to also receive 2% of the net
21 gross sales of GOGV for a maximum of 10 years ("2% Agreement").¹ A&J also agreed
22 to maintain a \$100,000 term life insurance policy of \$100,000 on David Polsky.
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27 ¹ Plaintiff's Trial Exhibit A at E.

1 Also, on January 1, 2001, the Debtors executed a promissory note ("Note 1") for
2 \$50,000 at 11.5% in favor of the Thomas M. Peterson Trust ("Peterson Trust").
3 Peterson is the trustor, trustee and sole beneficiary during his lifetime of the Peterson
4 Trust. Note 1 is secured by a deed of trust ("DOT") on the Debtors' residence. The
5 Peterson Trust is the sole beneficiary of the DOT. A&J was not a party to Note 1.
6 Note 1 does not contain any references to the Investment Agreement. The Debtors
7 used the proceeds of Note 1 to open and operate GOGV.²

9 On December 22, 2002, the Debtors executed a second promissory note to the
10 Peterson Trust ("Note 2") for \$25,000 at 11.5% for approximately a four and one-
11 half year term. Note 2 is secured by the DOT and by term life insurance in the amount
12 of \$50,000.³ The Debtors used the proceeds of Note 2 in connection with GOGV's
13 operation.⁴

15 In 2002, Peterson agreed to purchase a Ford F250 truck ("Truck") for Polsky to
16 use at GOGV ("Ford Agreement"). Peterson financed the purchase of the Truck with a
17 bank. A&J paid all of the expenses related to the Truck. A&J also deposited into
18 Peterson's bank account the monthly payment due on the Truck. No written agreement
19 was executed regarding the Truck. After the Truck was paid off, it was totaled in an
20 accident. Peterson received approximately \$18,000 in insurance proceeds ("Insurance
21 Proceeds") for the Truck.

24 No evidence was presented as to whether Debtors used the Note 1 proceeds to
25 make capital investments in A&J or whether they loaned the Note 1 proceeds to A&J.

26 ³ Note 2 (Trial Exhibit D) does not specify whose life is being insured.

27 ⁴ See Note 2.

1 After the execution of the Investment Agreement and Notes 1 and 2, Peterson
2 and/or the Peterson Trust received regular monthly payments from A&J on Notes 1
3 and 2, as well as payments on the 2% Agreement. In mid-2006, all payments ceased.
4 At or about the same time, Peterson received the Insurance Proceeds.
5

6 **III. PROCEDURAL HISTORY**

7 The Debtors filed a Chapter 13 petition on October 14, 2005. On July 2, 2007, in
8 response to motions to dismiss their case on the grounds that their debts exceeded the
9 eligibility limits for Chapter 13, the Debtors converted their case to a Chapter 11.
10

11 On February 19, 2008, Peterson, in his capacity as Trustee of the Peterson
12 Trust, filed a motion for relief from stay ("MRS") so it could enforce its rights under the
13 DOT. The Debtors filed an objection to the MRS, asserting that the DOT was
14 improperly acknowledged and that substantial payments had been made on both
15 Notes 1 and 2 (collectively, the "Notes"). The Debtors further demanded an accounting
16 of how the Peterson Trust had applied payments on the Notes.
17

18 Various continued hearings on the MRS followed while the parties tried to reach
19 an agreement and exchanged accountings. On June 8, 2008, substitute counsel for the
20 Debtors filed a brief ("Usury Brief") which asserted that the "Peterson Loan" violated
21 Arizona's usury laws because there was allegedly no consideration for the 2%
22 Agreement and it is not referenced in either of the Notes.
23

24 On June 9, 2008, a continued evidentiary hearing on the MRS was held at which
25 the parties agreed to convert the MRS to an adversary proceeding. The MRS was
26 treated as a complaint for declaratory relief regarding the validity and extent of the DOT.
27 The Debtors' objection to the MRS was treated as an answer.
28

1 On June 19, 2008, the Debtors filed an amended answer ("Amended Answer")
2 and counterclaims ("Counterclaims"). The Amended Answer incorporated the Usury
3 Brief as a supplement to the Debtors' original objection to the MRS. The Counterclaims
4 alleged: (1) lack of consideration, (2) usury, (3) improper acknowledgment of the DOT,
5 (4) a demand for a turnover of the Insurance Proceeds, and (5) that Peterson had
6 violated the stay by refusing to turn over the Insurance Proceeds to the Debtors. On
7 July 22, 2008, the Peterson Trust filed a reply denying all of the Counterclaims. It also
8 asserted that the Court's jurisdiction was limited to the Trust and did not include
9 Peterson individually.
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12 Trial was continued by stipulation from August 21, 2008 to October 21, 2008. In
13 the Joint Pretrial Statement filed by the parties on October 17, 2008, the Debtors
14 abandoned their claim that the DOT had been improperly acknowledged. At the
15 commencement of the trial, counsel for the Peterson Trust announced that the parties
16 had agreed that the service of the Answer and the Counterclaims on the Trust would be
17 treated as proper service on Peterson individually "so that we can go forward with him
18 as a party as well."⁵
19

20 **IV. STATEMENT OF JURISDICTION**

21 This Court has jurisdiction over the Debtors and the Peterson Trust pursuant to
22 28 U.S.C. § 1334 and § 157(b)(2)(B) and (C). Peterson individually has consented to
23 the Court's jurisdiction to decide the Debtors' counterclaims. A&J is not a party and has
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27 ⁵ Transcript of October 17, 2008 Trial, p 16. Ins 18, 19.

1 not made an appearance in this adversary proceeding. The Court, therefore, does not
2 have jurisdiction over A&J or its claims.

3 **V. ISSUES TO BE DECIDED**

- 4
- 5 1. Should payments made under the 2% Agreement be applied to the
6 Notes?
 - 7 2. Are the Insurance Proceeds property of the Estate which must be turned
8 over to the Debtors?

9 **VI. DISCUSSION**

10 **A. The 2% Agreement Payments Cannot be Applied to the Notes**

11
12 In order to decide if the 2% Agreement payments can be applied to the Notes,
13 the nature of the legal obligations among the parties must be analyzed. That analysis
14 begins with an examination of the parties to each of the agreements. The parties to the
15 Investment Agreement are Peterson personally, the Debtors and A&J. The parties to
16 the Notes are the Peterson Trust and the Debtors. The parties to the Ford Agreement
17 are Peterson and A&J.

18
19 Next, the consideration exchanged among the parties to each of the agreements
20 must be reviewed. The evidence demonstrates the following:

- 21 1. Peterson did not make a \$50,000 investment (“\$50,000 Investment”) in
22 A&J as required by the Investment Agreement.
- 23 2. The Peterson Trust lent the Debtors the amounts recited in the Notes.
- 24 3. A&J paid for the Truck.

25
26 Peterson’s failure to make the \$50,000 Investment in A&J makes the Investment
27 Agreement unenforceable because of a lack of consideration. See Rogus v. Lords, 804

1 P.2d 133, 135 (Ariz. Ct. App. 1991) (A contract, to be legally enforceable, must be
2 supported by consideration). Consideration was given, however, by the Peterson Trust
3 to the Debtors when it lent the Debtors the amounts set forth in the Notes.
4
5 Consideration was given by A&J to Peterson and by Peterson to A&J because A&J paid
6 for the Truck and Peterson permitted A&J to use it for its business purposes.

7 The Debtors argue that because all of the payments on the Notes were made by
8 A&J "on behalf of the Debtors," that the Court should collapse and combine the
9 obligations and the parties to the Investment Agreement and the Notes into one unified
10 transaction, effectively making Peterson individually and A&J parties to the Notes and
11 making the Peterson Trust a party to the Investment Agreement. The Debtors further
12 argue that the substance of that unified transaction was usurious because the only
13 consideration given by Peterson for the 2% Agreement was arranging for the Peterson
14 Trust to make the loans described in the Notes, but the Notes contain no reference to
15 the 2% Agreement.⁶ If the Investment Agreement and the Notes' transactions are
16 treated as one unified transaction and the Court finds that payments on the 2%
17 Agreement violated Arizona's usury laws, then the Debtors argue all payments made on
18 the 2% Agreement should be applied to the Notes.
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21 The Debtors' argument requires a finding that A&J and the Debtors are
22 effectively one and the same. A court can disregard the corporate form if: (1) the
23 individuality that separates the corporation and owners ceases to exist, and
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26 ⁶ The Debtors also argue that Peterson violated Arizona's mortgage broker
27 licensing statutes in arranging for the Peterson Trust to make the loans of the Notes. Since
28 the Court has found that the Investment Agreement is unenforceable, it need not reach that
issue.

1 (2) observance of the corporate form would sanction a fraud or promote injustice. Dietel
2 v. Day, 492 P.2d 455, 457 (Ariz. Ct. App. 1972) (citing Employer's Liability Assurance
3 Corp. v. Lunt, 313 P.2d 393, 395 (Ariz. 1957)). But, there was no evidence presented at
4 trial to support such an “alter ego” finding. Furthermore, A&J’s assets and liabilities
5 were not listed by the Debtors on their Schedules. The Debtors have not claimed that
6 they are doing business as A&J and they have not included A&J’s income and
7 expenses on their Schedules I & J. Even if Peterson and the Peterson Trust can be
8 viewed as the same entity for purposes of applying Arizona’s usury laws, that does not
9 mean that A&J and the Debtors can be considered as the same entities for purposes of
10 determining who is legally obligated to pay the Notes. There was no notice given to
11 A&J’s creditors that, as a result of this litigation, A&J could become a co-obligor on the
12 Notes or that Debtors claim priority rights as creditors or otherwise, which justifies A&J’s
13 payment of the Notes.⁷ Accordingly, the Debtors’ counterclaim seeking a declaration
14 that all payments made on the 2% Agreement be applied to the Notes must be denied.

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18 B. The Insurance Proceeds Are Not Property of the Estate

19 The undisputed testimony was that the Ford Agreement was between Peterson
20 and A&J. For the reasons explained above, the Debtors and A&J are distinct entities.
21 Any right to demand turnover of the Insurance Proceeds belongs to A&J, not the
22 Debtors. Accordingly, Peterson’s refusal to turn over the Insurance Proceeds did not
23 violate the stay.

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26 ⁷ The propriety of A&J’s Note payments “on behalf” of the Debtors cannot be
27 decided in this litigation. This Court lacks jurisdiction over A&J because it is not a party nor
28 has it otherwise appeared in this adversary proceeding or Debtors’ administrative
bankruptcy case.

1 **VII. CONCLUSION**

2 The Debtors, as A&J's sole members, may assert any claims A&J may have
3 against Peterson, but that does not mean that those claims belong to the Debtors.
4 Accordingly, A&J's claims cannot be used to offset Debtors' separate obligations to the
5 Peterson Trust. Judgment will, therefore, be entered this date against the Debtors on
6 their counterclaims.
7

8 DATED AND SIGNED ABOVE.

9
10 Notice to be sent through the
11 Bankruptcy Noticing Center "BNC"
12 to the following:

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