

BEFORE OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF:)
)
GORDON S. SCHOLLER AND) OTA CASE NO. 20056173
SHEILA G. SCHOLLER)
)
APPELLANTS.)
_____)

CERTIFIED COPY

VIRTUAL TRANSCRIPT OF PROCEEDINGS

Zoom Videoconference

Friday, September 27, 2024

Reported by:

SHELBY K. MAASKE
Hearing Reporter

Job No.:
50728 OTA

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15 TRANSCRIPT OF PROCEEDINGS, taken via
16 Zoom, commencing at 9:54 a.m. and concluding
17 at 1:37 p.m. on Friday, September 27, 2024,
18 reported by Shelby K. Maaske, Hearing Reporter.
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APPEARANCES :

Panel Lead: Hon. Amanda Vassigh

Panel Members: Hon. Cheryl Akin
Hon. Asaf Kletter

For the Appellant: Scott Scholler
Sheila Scholler,
Taxpayers

Mauro P. Colabianchi,
Attorney

For the Respondent: Brad Coutinho,
Franchise Tax Board

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I N D E X

E X H I B I T S

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Dan Hilderbrand	93
Chris LaBelle	98

1 Virtual Proceedings; Friday, September 27, 2024

2 9:54 a.m.

3
4
5 ADMINISTRATIVE LAW JUDGE VASSIGH: We are going
6 on the record. This is the appeal of Scholler, OTA Case
7 No. 20056173. The date is September 27, 2024, and the
8 time is 9:54 a.m. This hearing is being held
9 electronically with the agreement of the parties.

10 I am Judge Vassigh. I will be the lead judge for
11 the purpose of conducting this hearing. My co-panelist,
12 Judge Akin and Judge Kletter and I, are equal participants
13 in deliberating and determining the outcome of this
14 appeal.

15 I'm going to ask the parties to identify
16 themselves and who they represent, starting with the
17 Franchise Tax Board.

18 MR. COUTINHO: Good morning. My name is Brad
19 Coutinho and I represent Respondent, Franchise Tax Board.
20 Thank you.

21 ADMINISTRATIVE LAW JUDGE VASSIGH: Good morning.
22 Thank you.

23 Okay. And for Appellant, who do we have?

24 MR. COLABIANCHI: Good morning, your Honor. This
25 is Mark Colabianchi. I represent Appellant, Scott and Gay

1 Scholler.

2 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you so
3 much.

4 And I believe we saw Mr. Scott Scholler here
5 today.

6 MR. SCHOLLER: Yes, I'm Scott Scholler. I am the
7 taxpayer.

8 ADMINISTRATIVE LAW JUDGE VASSIGH: And Gay
9 Scholler is also here today.

10 MR. SCHOLLER: She's in the waiting room.

11 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay. That is
12 fine. Thank you.

13 All right. As stated in the minutes and orders,
14 the issues to be decided in this appeal and that parties
15 have agreed to are, one, whether Appellants are entitled
16 to a bad debt deduction for 2003 tax year. Two, whether
17 Appellants are entitled to worthless stock deduction for
18 the 2003 tax year. Three, whether the accuracy-related
19 penalty should be abated. And four, whether any interest
20 should be abated.

21 I'm going to move on to our exhibits. I know we
22 have a bit to discuss in that regard. Appellants had
23 submitted Exhibits 1 through 14 after the prehearing
24 conference. Franchise Tax Board did not object to the
25 admissibility of these exhibits and, therefore,

1 Appellants' Exhibits 1 through 14 are admitted into
2 evidence at this time.

3 (Appellant's Exhibits 1 through 14 were
4 marked for identification by the
5 Administrative Law Judge and received
6 in evidence.)

7 ADMINISTRATIVE LAW JUDGE VASSIGH: We will get to
8 Appellants' recent proposed exhibits. But I want to
9 mention first that FTB submitted Exhibits A through H and
10 Exhibits L through O, and it should be noted that FTB did
11 not submit exhibits labeled I, J, or K.

12 I decided not to relabel the exhibits following
13 Exhibit H in order that any references to exhibits remain
14 consistent with that in the briefing. So that should
15 avoid any potential confusion.

16 Appellants did not object to the admissibility of
17 these exhibits and, therefore, Exhibits A through H and
18 Exhibits L through O are admitted into evidence.

19 (Respondent's Exhibits A through H and
20 L through O were marked for identification
21 by the Administrative Law Judge and
22 received in evidence.)

23 ADMINISTRATIVE LAW JUDGE VASSIGH: So earlier
24 this week Appellants proposed additional exhibits, 15
25 through 18. These were a late submission. Proposed

1 Exhibits 16, 17, and 18, to my understanding, were in
2 possession of a witness, Mr. Ralph Bagley, who recently
3 found them in a mislabeled file, so Appellants did not
4 have possession of those exhibits until recently.
5 Proposed Exhibit 15 was not earlier submitted due to a
6 miscommunication to Mr. Scholler and his representative.

7 Do I understand that correctly?

8 MR. SCHOLLER: Yes, I think so. That sounds
9 right.

10 ADMINISTRATIVE LAW JUDGE VASSIGH: So I
11 determined that that does not qualify as good cause for
12 late submission, but we can discuss Exhibits 16, 17, and
13 18. I want to check in with Mr. Coutinho.

14 Does FTB have an objection to the admittance of
15 proposed Exhibits 16, 17, and 18?

16 MR. COUTINHO: Yes. Respondent does object to
17 those exhibits as stated in the prehearing conference
18 minutes and orders. The deadline to submit additional
19 exhibit was September 12th, and this was an extension of
20 September 3rd deadline due to the moving of the hearing
21 date.

22 The exhibits were received on September 25th,
23 almost two weeks after the deadline stated in the
24 prehearing conference minutes and orders and, thus,
25 Respondent does not have sufficient time to evaluate the

1 evidence presented, evaluate it, and determine the
2 veracity of it and how it may alter its position. And for
3 those reasons, Respondent objects to those exhibits.

4 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you,
5 Mr. Coutinho. If these exhibits were to be admitted,
6 would FTB like post-hearing briefing? We can't hear you.

7 MR. COUTINHO: Sorry. I clicked the wrong
8 button. Yes. In the event that these exhibits are
9 admitted, again, Respondent objects to the admission of
10 them, but in the event they are admitted into the record,
11 Respondent would then request a post-additional brief.

12 ADMINISTRATIVE LAW JUDGE VASSIGH:
13 Mr. Colabianchi, can you please speak to your argument
14 that there is good cause for the late submission of these
15 proposed exhibits?

16 MR. COLABIANCHI: Yes. So for these exhibits,
17 based on our knowledge of the records of the company at
18 issue here, we believed they had been destroyed
19 previously. Mr. Bagley, when he was reviewing something
20 -- some files he had to refresh his recollection, it was
21 in an unrelated folder. I believe it was having to do
22 with the development of the software.

23 Scott, can you correct me if I'm wrong on that?

24 MR. SCHOLLER: We were -- he was looking for the
25 exact dates of release for each of the game titles, and

1 the software you keep is a -- you have a gold copy, which
2 is kind of the master, from which games were replicated,
3 and so that was where it was labeled, but a back-up file
4 had been made and it happened to include those items. So
5 if he hadn't have been looking for specific dates on the
6 release of the games, he probably never would have noticed
7 them.

8 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay. Thank
9 you.

10 Mr. Colabianchi, anything else to add?

11 MR. COLABIANCHI: No, I don't believe so. We --
12 just one thing, these include the balance sheet and a
13 profit and loss statement, so these would be financial in
14 nature and you wouldn't expect them to be in this kind of
15 folder where it's discussing about the -- the folder
16 having to do with the development of the software
17 specifically.

18 ADMINISTRATIVE LAW JUDGE VASSIGH: And it looks
19 like the Panel has come to a decision on this. Since the
20 exhibits were not in Appellants' possession and were
21 recently discovered, for good cause, we are going to admit
22 Exhibits 16, 17, and 18 into the record. And we are going
23 to allow FTB post-hearing briefing to address those
24 exhibits if FTB finds that necessary.

25 Appellants indicated during our prehearing

1 conference that they will be presenting testimony or
2 written declaration from the following individuals:
3 G. Scholler, S. Scholler, Dave Caputo, Doug Detrick,
4 Chris Perkins, Dan Hilderbrand, Chris LaBelle, and Ralph
5 Bagley. FTB did not raise objections to any of the
6 witnesses.

7 Before we begin Appellants' presentation, I will
8 place -- well, actually, I remember we had a request this
9 morning that each witness be sworn in individually. So
10 what we were going to do is, Mr. Colabianchi, you have
11 15 minutes for your opening presentation and then you will
12 have up to two and a half hours to present witness
13 testimony.

14 I will swear in each witness before they testify
15 and they will remain under oath until the close of this
16 hearing. Mr. Colabianchi, you can have the witnesses
17 testify in the narrative form or you may ask them specific
18 questions. Please proceed when you are ready.

19 MR. COLABIANCHI: Thank you, your Honor.

20 This case is about a short-term loss based on the
21 Scholler's 2003 tax return. The loss originates from a
22 non-business bad debt deduction of \$1,233,460.00. The bad
23 debt this refers to is a series of short-term loans given
24 by Scott Scholler to a company call N'Lightning Software
25 Development, Inc. or NSDI.

1 NSDI was in the video game business specifically
2 targeting a Christian, family-friendly market. While
3 initially successful, NSDI ultimately closed in 2023, and
4 NSDI was unable to repay the loans Scott had made to it,
5 and Scott, therefore, took the bad debt deduction.

6 While this deduction was ultimately disallowed by
7 the IRS, we intend to show that this deduction was
8 properly taken and only through a series of
9 miscommunications did the tax due become final with the
10 IRS. To prove that this deduction was properly taken, you
11 must first show that the Schollers did, indeed, transfer
12 funds to NSDI.

13 We will hear testimony from NSDI's former CEO,
14 director of marketing, and others to corroborate these
15 payments. We have also admitted wire instructions and
16 bank statements in the record to prove these payments took
17 place.

18 Secondly, we will show that these loans qualified
19 as bona fide debts. Under federal tax law filed by
20 California, a bona fide debt is a debt which arises from a
21 debtor-creditor relationship based upon the valid and
22 enforceable obligation to pay a fixed or determinable
23 amount of money. For a debt to qualify for the bad debt
24 deduction, it must have been a bona fide debt.

25 I would like to clarify that there were, in fact,

1 three lending events with NSDI as the borrower and Scott
2 Scholler as the lender. The first lending event started
3 in 2000, when Scott agreed to loan just under \$850,000.00
4 to NSDI.

5 ADMINISTRATIVE LAW JUDGE VASSIGH: It looks like
6 we have lost Mr. Colabianchi again.

7 MR. COLABIANCHI: I apologize. I'm having
8 technical issues on my end. It wasn't happening before
9 this morning, so bear with me again. I'm sorry.

10 ADMINISTRATIVE LAW JUDGE VASSIGH:
11 Mr. Colabianchi, why don't we try turning off your video
12 so that maybe we are not taking up --

13 MR. SCHOLLER: It's jumping, so your bandwidth
14 seems low.

15 MR. COLABIANCHI: I'll try that.

16 ADMINISTRATIVE LAW JUDGE VASSIGH: And I'm going
17 to also let the parties know we are going to take a break
18 at the 90-minute mark. So I will give you a little heads
19 up when we hit that point. And if someone is testifying,
20 we will let them finish their sentence or train of thought
21 and we will take a little break at that point.

22 Mr. Colabianchi, back to you.

23 MR. COLABIANCHI: Okay. Thank you. Can you hear
24 me?

25 ADMINISTRATIVE LAW JUDGE VASSIGH: We can hear

1 you.

2 MR. COLABIANCHI: Thank you.

3 The first lending event started in 2000 when
4 Scott agreed to loan just over \$850,000.00 to NSDI. These
5 loan disbursement were ultimately made in two
6 installments, one in 2000 and one in early 2001. This
7 lending event was not included in the calculation of the
8 bad debt deduction; however, we will ask the witnesses
9 about this loan in order to show that there was a
10 lender-borrower relationship between Scott Scholler and
11 NSDI.

12 The second lending event started in June 2001,
13 when Scott agreed to provide short-term loans to the
14 business to help with development and marketing of its
15 second video game title. These loans ultimately equaled
16 approximately \$800,000.00. This loan was included in the
17 calculation of the bad debt deduction.

18 The final lending event has to do with an
19 unsecured line of credit provided to NSDI by Home Valley
20 Bank started in September 2000. This line of credit was
21 renewed in 2001 and the interest rate was reduced in early
22 2002. In June 2002, Home Valley Bank was sold and a new
23 owner, on very short notice, less than 30 days, directed
24 the whole line be called which included the line of credit
25 with NSDI. Scott Scholler refinanced this line of credit

1 of \$400,000.00 and stepped into the shoes of the bank.

2 We will show, using objective indicators, that
3 both the second and third lending events were bona fide
4 debts in that they, one, have the correct form of the
5 instrument to be consider a loan, interest was charged,
6 and promissory notes were drafted, and there was a board
7 meeting to memorialize the agreement.

8 Number two, the intent of the parties was that
9 these payments would be loans and NSDI intended to repay
10 the loans as Scott intended to be repaid.

11 Number three, the objective and economic reality
12 show that this was a loan. First, NSDI secured a
13 third-party lender, Home Valley Bank, showing third
14 parties would, indeed, loan to NSDI. And second, at the
15 time of the loans, there was a reasonable expectation that
16 NSDI's sales would be at a level to fully repay Scott
17 Scholler.

18 Counsel for Respondent has argued that Scott's
19 transfer of these funds was a gift or a paid in capital.
20 Scott received a 20 percent interest in the company to
21 provide NSDI with the first loan of just under
22 \$850,000.00. A granting of shares as an incentive to
23 provide debt financing was an often-used practice by
24 startup companies.

25 This agreement was drafted by Roger Rappoport who

1 headed up the Emerging Growth and Venture Capital
2 Practice, however, these loans were not included in the
3 calculation of the bad debt deduction. They weren't part
4 of the deduction. The short-term loans Scott provided in
5 June 2001 were not connected to the first loan agreement
6 and these made up the bulk of the debt that was written
7 off, over \$800,000.00 worth.

8 ADMINISTRATIVE LAW JUDGE VASSIGH:

9 Mr. Colabianchi? Sorry. That last sentence you were kind
10 of in and out. Can you repeat the last sentence, please?

11 MR. COLABIANCHI: Sure. The short-term loans
12 Scott provide starting in June 2001 were not connected to
13 first loan agreement and these made up the bulk of the
14 debt which was written off, over \$800,000.00 worth.

15 The last element that must be proved is that the
16 debt at least was worthless in the year that the deduction
17 was taken. In our case, the deduction was taken in 2003.
18 We have several objective identifiable events which point
19 to the debt being worthless in 2003.

20 Number one, the sales of NSDI's
21 highly-anticipated second title were lower than expected,
22 and NSDI was unable to secure distribution agreements for
23 their product.

24 Number two, Michael Acton, a person at NSDI
25 contracted to provide accounting services to the company,

1 was discovered to have embezzled more than \$115,000.00
2 from NSDI. This discovery happened in May 2023. Our
3 witnesses will testify how this embezzlement damaged the
4 business.

5 And three, due to lower sales and revealed
6 embezzlement, NSDI let go of its entire staff in
7 September 2003. IRS records will prove that 2003 was the
8 last year NSDI issued payroll.

9 Number four, a letter from CEO Ralph Bagley to
10 Scott Scholler dated December 22, 2003, states that NSDI
11 will not be able to repay the debt to Mr. Scholler. These
12 events taken together show that NSDI's debt to Scott
13 Scholler was utterly worthless in 2003, and therefore, it
14 was proper for the Schollers to take this deduction on
15 their 2003 return.

16 In conclusion, these debts were bona fide
17 worthless in 2003, they were properly written off as bad
18 debt in 2003.

19 Moving on to the penalty. Under Neonatology
20 Associates Vs. Commissioner, Tax Court case, taxpayers
21 will not be held liable for accuracy-related penalties if
22 they relied upon their tax professionals for their
23 reporting positions. The tax court set forth a
24 three-prong test for the taxpayer to show reasonable
25 reliance on a tax professional.

1 The first prong is whether the advisor was a
2 competent professional who had sufficient expertise to
3 justify a reliance. The second prong is whether the
4 taxpayer provided necessary and accurate information to
5 the advisor. The third prong is whether the taxpayer
6 actually relied in good faith on the advisors judgment.
7 We believe this test has been met by my client, and thus,
8 he should not be held liable for the proposed
9 accuracy-related penalty.

10 My client discussed the bad debt deduction with a
11 financial advisor, Richard Berry, and he reasonably relied
12 on his advice when he claimed it in 2003, therefore, the
13 accuracy-related penalty should be abated.

14 Regarding the interest abatement, Franchise Tax
15 Board issued a Notice of Proposed Assessment to my client
16 in 2009, and it was timely protested. My client was still
17 trying to have the IRS reconsider the outcome of the IRS's
18 prior audit, and therefore, the Franchise Tax Board
19 granted him time to try to obtain this reconsideration.

20 However, the last time the FTB issued a letter to
21 my client before the Notice of Action in 2020 was in 2016.
22 We believe this is attributable in whole or in part to an
23 unreasonable delay on the part of the Franchise Tax Board.
24 No significant aspect of the delay after 2016 was due to
25 actions attributable to my client. The FTB could have

1 issued the Notice of Action at any time.

2 They also occurred after the FTB first contacted
3 the taxpayer as the Notice of Proposed Assessment was
4 issued in 2009; therefore, we believe the interest of 2016
5 to 2020 should be abated.

6 That ends my opening statement. Thank you.

7 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you,
8 Mr. Colabianchi.

9 I'm going to turn to my co-panelists to see if
10 they have any questions for you. I'll start with Judge
11 Kletter. Do you have any questions?

12 ADMINISTRATIVE LAW JUDGE KLETTER: This is Judge
13 Kletter. No questions at this time. Thank you.

14 ADMINISTRATIVE LAW JUDGE VASSIGH: Judge Akin, do
15 you have any questions?

16 ADMINISTRATIVE LAW JUDGE AKIN: Also no questions
17 at this time. Thank you.

18 ADMINISTRATIVE LAW JUDGE VASSIGH: I do have one
19 question. Mr. Colabianchi, regarding the accuracy-related
20 penalty, you mentioned that Appellants relied on the tax
21 professional for this position. Is there any
22 documentation of that legal position?

23 MR. COLABIANCHI: I don't believe there would be
24 a written legal position by Mr. Berry in the record.

25 Scott, do you have any -- could I ask Scott if he

1 has any input on that?

2 MR. SCHOLLER: No, I'm not sure I quite
3 understand the question. Regarding --

4 MR. COLABIANCHI: So when you spoke to Mr. Berry
5 about the bad debt deduction, did he issue any kind of
6 opinion letter you should take the deduction in 2003 or
7 any other documentary substantiation?

8 MR. SCHOLLER: Maybe. I didn't -- I haven't been
9 looking for that. I mean, there's a lot of correspondence
10 between Ayco Asset Management Richard Berry and myself at
11 around that time.

12 ADMINISTRATIVE LAW JUDGE VASSIGH: I'm going to
13 stop us right here because Mr. Scholler is giving
14 testimony, so I would like to swear you in so I can
15 consider what you are saying as part of the record. So
16 can you please, at this point, raise your right hand.

17
18 SCOTT SCHOLLER,
19 having been first duly sworn was examined and testified as
20 follows:

21
22 MR. SCHOLLER: I do.

23 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay. So
24 Mr. Scholler, you are sworn in and you will remain under
25 oath for the remainder of this hearing. You may proceed

1 answering the question. What I specifically want to know
2 is do you have any documentation -- any e-mails or a
3 letter from the tax preparer documenting that this was the
4 position that --

5 MR. SCHOLLER: I may. It would take me -- it
6 would probably take me a few minutes to figure that out.
7 Maybe when we take a break I will attempt to do that.

8 ADMINISTRATIVE LAW JUDGE VASSIGH: No, it's okay.
9 I was just asking if it's already in the record.

10 MR. SCHOLLER: However, the meeting where that
11 was discussed was in tax preparation for the year 2003.
12 As he did every year, Richard would come to our home and
13 it was around the kitchen table with myself, Richard, and
14 my wife, who will be providing testimony later.

15 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay. Thank
16 you.

17 Mr. Colabianchi, who would you like to call as
18 your first witness? Mr. Colabianchi, can you unmute?

19 MR. COLABIANCHI: Yes, I'm back. I think I'll
20 try to call in, if that's all right with your Honor?

21 ADMINISTRATIVE LAW JUDGE VASSIGH: That's
22 absolutely fine.

23 MR. COLABIANCHI: Could we have a five-minute
24 recess to see if I can work with these issues I'm having?

25 ADMINISTRATIVE LAW JUDGE VASSIGH: That's fine.

1 We can do that. So if everyone can still please stay on
2 the Zoom but go ahead and turn off your audio if it's on,
3 and turn off your video. We will see you at 10:23.

4 MR. COLABIANCHI: Thank you.

5 ADMINISTRATIVE LAW JUDGE VASSIGH: Off the
6 record.

7 (There was a pause in the proceedings.)

8 ADMINISTRATIVE LAW JUDGE VASSIGH: Back on the
9 record. Let's see and just make sure that we have
10 Mr. Colabianchi available for us. I do not see him.
11 Okay. So looks like he's still working on that. Our
12 office is going to give him a call. Let's go back on a
13 little break. We will go off the record for a moment and
14 I will come back when I'm given a heads up that he has
15 returned. So please, again, turn off your video and turn
16 off your audio.

17 (There was a pause in the proceedings.)

18 ADMINISTRATIVE LAW JUDGE VASSIGH: So we are now
19 back on the record. And Mr. Colabianchi, you are going to
20 tell me which witness you would be calling first.

21 MR. COLABIANCHI: I'd like to call Scott Scholler
22 first, please.

23 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay.
24 Wonderful. My understanding is that, available to us, we
25 have Mr. Scholler, Mrs. Scholler, Doug Detrick, Chris

1 Perkins, and Ralph Bagley. So if possible, I would like
2 those individuals to be sworn in together just to save us
3 a little bit of time. So I'm going to just go and check
4 -- you can unmute yourself by pressing star 6. Really
5 quick, I think we have Gay Scholler.

6 Just let me know you are here.

7 MRS. SCHOLLER: I'm here.

8 ADMINISTRATIVE LAW JUDGE VASSIGH: Wonderful.

9 Scott Scholler, just confirm that you are still
10 with us here.

11 MR. SCHOLLER: Yes.

12 ADMINISTRATIVE LAW JUDGE VASSIGH: Doug Detrick?
13 I don't have him yet.

14 Chris Perkins?

15 MR. PERKINS: Yes, your Honor. I'm here.

16 ADMINISTRATIVE LAW JUDGE VASSIGH: Ralph Bagley?

17 MR. BAGLEY: Yes, your Honor. I'm here too.

18 ADMINISTRATIVE LAW JUDGE VASSIGH: And I do see
19 Doug Detrick on the line. So Mr. Detrick, can you press
20 star 6, since it looks like you're calling in, and just
21 confirm that you can hear me. So I will swear him in
22 later.

23 For Gay Scholler, Scott Scholler, Chris Perkins,
24 and Ralph Bagley, I would ask that you please raise your
25 right hand.

1 GAY SCHOLLER, SCOTT SCHOLLER, CHRIS PERKINS, AND
2 RALPH BAGLEY,

3 having been first duly sworn, were examined and
4 testified as follows:

5
6 MR. BAGLEY: I swear.

7 MS. SCHOLLER: I do.

8 MR. PERKINS: Yes, I do.

9 MR. SCHOLLER: I do.

10 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you.

11 You are under oath and you will remain under oath
12 until the close of this hearing. Everyone but
13 Mr. Scholler can go back to the waiting room, but I ask
14 that each witness stay with us available in case there are
15 any questions from the Franchise Tax Board representative
16 or any of the panel members.

17 So Mr. Colabianchi, please proceed with your
18 witness presentation.

19 MR. COLABIANCHI: Thank you, your Honor.

20
21 DIRECT EXAMINATION

22 BY MR. COLABIANCHI:

23 Q Good morning, Mr. Scholler.

24 A Good morning.

25 Q As you and the Panel are aware, this case

1 involves the question as to a deduction of over
2 \$1.2 million on your 2023 tax return, it's a non-business
3 bad debt. I would like to start with background
4 information and give the Court your involvement with the
5 (unintelligible).

6 Throughout this hearing I will be referring to
7 N'Lightning Software Development, Inc. as NSDI. Can you
8 please provide us with a summary of your business and
9 profession background prior to and during the time you
10 were a lender to NSDI?

11 A Certainly. After graduating West Point, I served
12 eight and a half years on active duty in the military.
13 When I went off of active duty, I joined Applied Materials
14 in the Bay Area, and over the course of the years that
15 followed leading up to when I provided loans to
16 N'Lightning, I was an executive in four startups and one
17 turnaround of a failing company.

18 Those four startups ended up, two via merger and
19 one is still now a 30-year-old public -- employee-owned
20 company --

21 (Internet interruption.)

22 ADMINISTRATIVE LAW JUDGE VASSIGH:

23 Mr. Colabianchi and Mr. Scholler, I'm going to ask that
24 you present that testimony again starting with where you
25 left off that Ms. Maaske heard.

1 THE WITNESS: I think I can recall it. So where
2 I left off was one is now a 30-year-old, employee-owned
3 company. I misstated when I said public. It's an
4 employee-owned company. And the last two were -- became
5 public companies via IVO. I was -- at the time that I was
6 -- at the time that I was introduced to N'Lightning, I was
7 in discussions with that last company, Interlays
8 Corporation, and I went off on the side -- which I'll
9 leave out at this time. But so, yes, that's my
10 background.

11 BY MR. COLABIANCHI:

12 Q Okay. Thank you, Scott.

13 I believe you mentioned Ralph Bagley, or you may
14 have mentioned it, but I'm going to ask you about several
15 individuals and how you know them and how they're related
16 to NSDI. So the first name would be Ralph Bagley. How do
17 you know him and what was he to NSDI?

18 A Ralph Bagley was the CEO of N'Lightning. I was
19 introduced -- or he was referred to me by Russ Holm, who
20 was a classmate of mine at West Point and were in the same
21 year group and company, so that's, like, 20 people, so we
22 knew each other pretty well.

23 After I was -- when we started out, he was at LSI
24 Logic when I was at Applied Materials, so we kind of
25 traveled in the same circles and he knew me pretty well.

1 He's the founder and managing partner at Legacy Ventures,
2 I believe it's now called Next Legacy. Ralph had met with
3 him. And while it wasn't a good fit for Legacy Ventures,
4 he thought it might be something I was interested in, so
5 he referred Ralph to me.

6 Q Okay. And I'll get back to that. But I want to
7 move on to a couple mores names. Dave Caputo, are you
8 familiar with that name?

9 A Yes. Dave Caputo was in charge marketing and
10 sales at N'Lightning, and I believe we met once or twice.

11 Q And then Chris Perkins?

12 A Chris Perkins was the project lead, slash, lead
13 developer for the -- N'Lightning's games.

14 Q Doug Detrick?

15 A Doug Detrick was one of the original lenders to
16 the company and a board member.

17 Q And then the last name is a Michael Acton?

18 A Michael Acton was a person that N'Lightning
19 contacted with to provide payroll and accounting services
20 to the company. I spoke with him on the phone and
21 exchanged e-mails with him on occasion mostly related to
22 the loans.

23 Q Okay. And I'll get back to him later; however,
24 I'd like to go back to Ralph Bagley, that you talked to
25 him and he thought you might be interested in his

1 business. So when and how was the pitch made to you to
2 provide loans to NSDI, the business he was the CEO of?

3 A Early in 2000, January, I believe, he came to
4 where I lived in Poway, California, and introduced
5 himself. Russ had already called me and told me he would
6 be contacting me, and so he presented his concept or
7 ideas, they had a demonstration of the software of the
8 game, and, you know, basically told me that they were
9 looking for debt financing to get the company going. That
10 was it.

11 He had some other discussion about the market,
12 the size, and that. As a Christian, as a parent, as a
13 video game player, and as a parent of children who were
14 video game players, I kind of understood the market a
15 little bit, although it's not something I had ever dabbled
16 in, and, you know, what they were proposing had a certain
17 level of appeal.

18 Q Why was debt financing the chosen route rather
19 than equity financing?

20 A Well, in my experience, and in early-stage
21 companies, at the seed or what is commonly referred to as
22 the angel phase of a business startup, debt financing
23 loans are often the direction to go. I mean, you only
24 have a concept. You don't have a product, you don't have
25 sales. Until you get to those levels venture capital

1 money isn't going to be available to you.

2 Since you don't have any of those things, what --
3 selling shares of the company, you know, you are probably
4 not going to. One is venture capital companies are
5 probably not even going to talk to you. And second, if
6 you were, you would give up, basically, most of your
7 shares of the company for probably not enough money to get
8 you going.

9 So, you know, debt financing -- even in large
10 companies, like when I was at Simer, that had millions of
11 dollars raised from who would be their customers, which
12 were 9th on Cannon, ASML and SVGL, and the form of that
13 money in was all in convertible ventures, basically, loans
14 that, at a point in time in the future, the lender could
15 choose to convert to shares at a predetermined price, but
16 the fact is is they're loans. Right. So you know, I'm
17 familiar with debt financing as a vehicle in startups.

18 Q What form of agreement was there? A promissory
19 note?

20 A Yeah. They didn't have an agreement, so I said,
21 well, I can have -- I'll have Roger Rappoport, who was the
22 head of Emerging Growth and Venture Capital Practice for
23 Procopio -- Cory, Savitch & Hargreaves, LLP -- and
24 somebody that I had worked with or had worked with
25 companies I've been in for some time, he prepared the

1 agreement, you know, which included, you know, the -- that
2 it was a loan, and that it came with a stock grant, and a
3 seat on the board. So yeah, it's a multipage document
4 that you have got there somewhere.

5 Q So what was the interest rate, do you recall?

6 A Not offhand. I think -- as I recall, it was --
7 it was fairly high.

8 Q Okay. And did you expect to be repaid?

9 A Absolutely.

10 Q When did you make the first loan and how much was
11 it?

12 A We -- the document, it specified two tranches.
13 The first tranche was in March and it was for \$400,000.00.
14 The second tranche was slated for August, but then, by
15 mutual agreement, we -- N'Lightning allowed that it be
16 broken up into smaller tranches.

17 Q Okay. Let me see. To your knowledge after you
18 provided these initial loans, did NSDI receive financing
19 from any other sources?

20 A Yes, in September of 2000 N'Lightning reached an
21 agreement with Home Valley Bank to provide an unsecured
22 line of credit ostensibly for the acquisition of inventory
23 -- video games and the attended materials like displays
24 and so on. While I wasn't part of that negotiation,
25 because I was the first lender, I had to sign off on the

1 agreement -- or I was asked to sign off. I don't know if
2 I had to.

3 But anyway, so yes, they had an unsecured line of
4 credit for \$400,000.00 from Home Valley Bank.

5 Q Okay. I want to come back to this. But
6 something regarding the first loan you made NSDI, two
7 payments, did you include that in your calculation for the
8 bad debt deduction? Was that included in the amount that
9 was deducted?

10 A No.

11 Q Okay. Okay. Returning to Home Valley Bank.
12 What happened to this line of credit with them that NSDI
13 has?

14 A Well, it was renewed in 2001. Along the way,
15 there were several times where they reduced the interest
16 rate.

17 Q Okay.

18 A For the line of credit. Sometime in the early
19 spring of 2002, they reduced the rate the last time.
20 Ralph, in one of the telephone calls -- Ralph Bagley, the
21 CEO, in one of the phone calls, indicated they intended to
22 renew the line of credit further.

23 The VP in charge at Home Valley Bank had said
24 that. But be that what it may, in June, Home Valley Bank
25 was sold to another bank. I don't know the name of it.

1 And they -- the new owner wasn't going to be in the
2 business of providing lines of credit to anybody, so they
3 called them all, which included N'Lightning, and it --
4 with less than 30 days notice, which, as you can imagine,
5 caused a panic situation. So because it had taken months
6 to negotiate the first line of credit, finding someone to
7 replace it was going to be -- put a real strain on the
8 company.

9 Q Can you describe a little bit more why the line
10 of credit canceled?

11 A Yeah. They got out of the business. It wasn't
12 because of noncompliance or anything like that. It is --
13 the new bank owner wasn't going to be -- you know, they
14 were more of a retail bank and they were getting out of
15 commercial banking, and so the lines of credit, they just
16 called them all to be paid out by the end of June.

17 Q What happened to the line of credit after that?

18 A Well, the company attempted to negotiate or find
19 a new -- a new bank to assume the line of credit, but if
20 you don't have a relationship with a bank, that's going to
21 be pretty hard. The only bank that had any sort of
22 relationship -- and I'm not even sure what that was,
23 whether it was N'Lightning or one of the board members,
24 whomever it was, with Bank of America.

25 Bank of America would not do an unsecured line of

1 credit, so their terms were that all of the existing
2 shareholders in N'Lightning provide personal guarantees
3 for the line of credit.

4 Q Okay.

5 A That turned out to be not something that was
6 palatable to the shareholders -- the other shareholders.
7 And so you are now faced with one of two possibilities:
8 Default on the line of credit, which, you know, would
9 essentially crater the company immediately, or somebody
10 needs to step in.

11 So I -- I didn't really want to, but I stepped in
12 and assumed the line of credit basically under the same
13 terms as had been with Home Valley Bank. It wasn't like
14 we wrote a new agreement with different terms, it's, like,
15 I'll just assume the line of credit under the existing
16 terms and conditions.

17 Q So would it be fair to say you stepped into the
18 shoes of the bank?

19 A Yes, yes, it would be fair to say I became the
20 bank, the Bank of Scholler.

21 Q When you assumed the line of credit in June 2022,
22 did you receive any shares of the company?

23 A No.

24 Q Did you include this line of credit that is in
25 issue with the bank or did you include that in the bad

1 debt deduction?

2 A I believe so, yes.

3 Q Okay. Let's see. We looked at one point --
4 well, I'll return to that.

5 I want to move to the loans at issue. Do you
6 have Appellants' Exhibit 1 there?

7 A Do I?

8 Q Yeah. I don't know -- I don't think I can bring
9 it up.

10 A I have things on my tablet here.

11 Q Yeah.

12 A Exhibit 1. Okay. Yeah.

13 Q Okay. I have this labeled as Restructure of
14 Loans from you to NSDI, first came in -- dated June 4,
15 2001; is that correct?

16 A Yes.

17 Q What happened in June 2001?

18 A The company's sales were not ramping up as
19 quickly as they had hoped. They're -- the initial
20 positioning or the initial thrust for their marketing and
21 sales was through Christian bookstores, Christian
22 retailers, and as reported to me -- to the rest of the
23 members of the board, and Ralph Bagley and Dave Caputo's
24 testament, it was simply a matter of retailer education.

25 This was something new to them, and they

1 basically had a hard time in knowing how to market and
2 sell it to retail customers, but they were taking steps to
3 remedy that. However, what that meant was you had two
4 things going on. One was the cash-flow needs of the
5 company based on their burn rate, and also, there were
6 compliance terms and conditions related to the line of
7 credit with Home Valley Bank that needed to be maintained.

8 I don't remember exactly what those were, but,
9 you know, it involved how much -- you know, maintaining
10 certain balances in their accounts, et cetera. So they
11 were -- you know, essentially needed additional cash, and
12 so I agreed to provide them -- this was believed to be a
13 short-term hump that they needed to get over, and I agreed
14 to provide a series of short-term loans as needed to, you
15 know, assure that they -- that their terms and conditions
16 with Home Valley Bank were met and their cash-flow needs
17 for continuing operations were met.

18 Q Was there a meeting or call where the loans were
19 discussed, or can you give us more information about that
20 if there was one?

21 A Sure. There was a board meeting. For me, it was
22 telephonic because they're in Medford, Oregon, and I was
23 in California, at which time the -- my offer of providing
24 short-term loans was discussed. It was a simple agreement
25 that was reviewed with the board of directors and approved

1 by them. Of course, I had to bow out of that portion of
2 the discussion for obvious reasons. Anyway, but yeah, it
3 was -- they had approved my providing the short-term loans
4 to the company.

5 Q Okay. Do you know who else was on the call when
6 it was discussed at the board meeting?

7 A I believe Doug Detrick was in the office with
8 them, although he may have been on the phone. That's a
9 better question for Doug. The -- I don't recall. I
10 believe all of the board members were there, which would
11 have include Cleta Charles. Unfortunately, she passed
12 away some years ago so it would be hard to ask her. So,
13 yeah.

14 Q Was Ralph Bagley on the call?

15 A Yeah, Ralph chaired the meeting.

16 Q Okay. What was the terms of the loans? You said
17 they were short term, but was there a repayment schedule
18 on interest rate?

19 A Well, obviously, if you are running short of
20 cash, the interest would be accrued and then when the
21 company's revenues or cash in exceeded their burn rate,
22 that would be -- the loans would be repaid on a
23 first-in-first-out basis, you know, so whatever -- in this
24 case, the June loan would be repaid first with the accrued
25 interest and then so on and until it was fully repaid.

1 Q Was there a written loan agreement for those
2 short-term loans?

3 A Yes.

4 Q Was it signed by the parties?

5 A I believe so. I wasn't in the room, but yes.

6 Q Was it signed by you?

7 A I believe so. I think the sequence was after
8 they signed it, it was sent back to me, you know, to be
9 signed -- but not as a board member, to be signed as the
10 lender.

11 Q Do you recall if it was mailed to you or faxed to
12 you?

13 A Not specifically, but most other things of that
14 nature were mailed to me, so I'm guessing it was probably
15 mailed.

16 Q Okay. I'd like to turn to the short-term loans,
17 so let's talk about them, how it was that you made these
18 loan disbursements to NSDI?

19 A Okay.

20 Q If you could explain?

21 A The implementing logistics of it were that it
22 would -- the requests would have to be approved by Ralph
23 Bagley. Sometimes I would get the request from Michael
24 Acton, but that was always followed up with an e-mail or a
25 phone call with Ralph to confirm, you know, because that

1 was the deal.

2 My requests were Ayco Asset Management provided
3 the umbrella financial management for me or for -- yeah.
4 And so the requests, primarily -- not entirely, I also had
5 accounts with Silicon Valley Bank. So in either case, it
6 would be -- I would send them a fax with the wiring
7 instructions for the amount to be disbursed to
8 N'Lightning.

9 On the other side, N'Lightning, you know, put
10 them on their books as a loan increment and they kept
11 track of them and then periodically -- usually, like, once
12 a month, would compare notes. You know, here's what we
13 received, here's what I authorized, and just made sure
14 that the two matched up. We wanted to keep it simple.

15 And at the time I was in the middle of -- I was
16 hired as the eleventh employee at Interlays. Two years
17 later, we had 100 and some employees. We were -- you
18 know, I had to build an FDA-approved manufacturing
19 facility to get FDA compliance. I was working 14 to 16
20 hours day six to seven days a week. I only provide that,
21 not for sympathy, but simply I had to keep it simple, you
22 know.

23 Q So can we return to the wire transfers?

24 A Yep.

25 Q Great. Exhibit 5, do you mind pulling that up?

1 It would be labeled -- if you are looking at the OTA Bates
2 stamp page, it's 8 of 99.

3 A All right. Let me see what it says here. I
4 don't think it says either one of those things.

5 Q It would be in the bottom middle where it's the
6 page number.

7 A I'm looking at the file. What I have up is OTA
8 CA-mysharepoint.com.

9 Q Yeah, go to page 89.

10 A Okay. Hang on. Let me get --

11 ADMINISTRATIVE LAW JUDGE VASSIGH: This is Judge
12 Vassigh. While you are looking that up, I do want to
13 mention that because we lost about six minutes of
14 Appellants' time, I did add to the end of your time,
15 Mr. Colabianchi, so you have until 12:45 to present the
16 witness testimony.

17 And just a reminder that for some of your
18 witnesses, we do have submitted declarations too, so if
19 you would like to avoid having them repeat that, you can
20 just let us know there is a submitted declaration and we
21 can allow for any additional information or questions for
22 Franchise Tax Board and the Panel.

23 MR. COUTINHO: Just to clarify, you were talking
24 about the entire witness testimony until 12:45; correct?

25 ADMINISTRATIVE LAW JUDGE VASSIGH: Yes, for all

1 witnesses.

2 MR. COUTINHO: Okay. Thank you very much.

3 BY MR. COLABIANCHI:

4 Q Were you able to get to that exhibit?

5 A Yes, I am here.

6 Q Okay. So we are on page 89, the OTA exhibit.

7 What is this document here?

8 A It's wiring instructions from me to Emily Clayton
9 at MSDW.

10 Q And how much was it for?

11 A \$21,000.00.

12 Q And what was the date these instructions were
13 sent?

14 A August 27th of 2001.

15 Q All right. And then can you go to the previous
16 page, please. It should be --

17 A It's bank statement.

18 Q Who's bank statement is this?

19 A It's N'Lightning's bank statement.

20 Q Great. And can you see midway down the page, is
21 there a deposit?

22 A Yeah, there's a deposit on 8/28 of 2001 from an
23 incoming wire of \$21,000.00.

24 Q Is this exhibit that would generally capture the
25 payments paid to NSDI under the short-term loan

1 agreements?

2 A Yes.

3 Q Okay. At this time how were NSDI's sales
4 progressing -- at this time when you began giving the
5 short-term loans, how were the sales progressing and what
6 do you recall about their financial situation?

7 A Well, you know, they still weren't at cash-rate
8 even, so that necessitated the short-term loans, but --
9 that's funny.

10 Q What were the prospects of the sales of their
11 software?

12 A They were starting to trend upward to -- sorry.
13 Just a second.

14 ADMINISTRATIVE LAW JUDGE VASSIGH: I'm going to
15 take this moment to remind you that if you are overlapping
16 each other in discussion, we lose something because
17 Ms. Maaske can only transcribe one part of the
18 conversation, so let's be careful not to overlap.

19 THE WITNESS: What was the question again?

20 BY MR. COLABIANCHI:

21 Q At this time when you started making the
22 short-term loans to NSDI, how were software sales and what
23 were the prospects for the second title?

24 A Well, the sales of Catechumen, running back to
25 the previous, was -- I mean, this is only a couple of

1 months later. They're still working on retailer education
2 and were taking some steps to provide better -- improved
3 tools, you know, like displays that you could use at an
4 end cap in a store. But a lot of it was you just had to
5 -- they just had to spend time with the retailers.

6 Their intent was -- again, you are a new genre.
7 There weren't Christian video games, or faith-based games
8 were not a genre of video games, just as if you went back
9 into the 50s as Christian music wasn't a genre in the
10 music industry. So there was a fair amount of work to be
11 done. So the sales were still low, but growing and
12 encouraging.

13 Q Did you receive anything for the short-term loans
14 other than promise to pay and interest repayment?

15 A No.

16 Q Did you receive any repayments for these loans?

17 A Not in that -- obviously, not in that timeframe,
18 but I may have in early 2003. I don't -- if it was, it
19 was minimal. I just don't recall.

20 Q But most of the funds you sent as well to NSDI
21 under the short-term loans were not repaid; is that
22 correct?

23 A Correct.

24 Q Okay.

25 A Let me clarify. If I received anything, it was

1 probably related to the line of credit, but I just don't
2 remember.

3 Q Okay. I want to pivot a little bit now. As you
4 know, one of the requirements for the bad debt reduction
5 that it is taken in the year when the debt becomes
6 worthless. The next question has to do with the closure
7 of NSDI's operations. You just testified that on the
8 whole NSDI did not repay you for the short-term loans.
9 Why did they not repay you?

10 A They didn't have the money.

11 Q Okay. When did you realize that they would not
12 be able to repay you?

13 A The wheels started coming off in early 2003 when
14 they discovered that they had been embezzled to the tune
15 of something over \$115,000.00, which translated to one
16 quarter's operating expenses. That, coupled with -- you
17 know, the year of 2003 was kind of a make-or-break year
18 for the company.

19 Prior to that, the focus had been on Christian
20 retailers, and then, in 2001, they shifted to youth groups
21 and the like. Something that Ralph can talk to later, I
22 guess. So the forecast -- the projections from fall of
23 2002 for the year 2003 showed the company selling
24 something around 250,000 games. That's a big number, but
25 not big in retail distribution.

1 They had done some pilot work with some major
2 retailers -- Target and Game Stop, were two that I
3 remember. There may be more. Again, that's a better
4 question for Ralph Bagley. But it was -- their
5 projections or forecast was initially dependent upon being
6 able to -- to get into the large retail distribution
7 channels.

8 So the combination of all of a sudden you realize
9 that you are \$115,000.00 or so lighter than you thought
10 you were, and you have records that have been destroyed,
11 both physical and digital, police reports, all of that
12 sort of thing, plus the impact of being able to get in
13 front of those retail distributors ended up -- and they're
14 were a few other thing -- of the kind of demand the major
15 companies, like, specifically WalMart being one of them --
16 and I don't know all of the specifics. Ralph could
17 probably talk to that as well.

18 But the end result was they were not going to be,
19 in any meaningful way, distributing through the likes of
20 Game Stop, WalMart, and/or Target for the holiday season
21 of 2003. That was the -- the games at this point --
22 Catechumen was released in 2000 and Ominous Horizons in
23 2001. Games have a relatively short life span.
24 Technology changes and so on. So a three or four-year old
25 game is not a seller. So if it got into retail

1 distribution in the U.S. in 2003, that opens up the doors
2 to international sales -- South Korea, Europe and so on.

3 It's not true anymore, but at that time, that's
4 the way most games traveled. It didn't include Japan
5 because they developed many of their own games. But games
6 developed in the U.S., if there was success in the U.S.,
7 then they could be successful in other markets. So when
8 all of that is missed, you know, you are not going to get
9 another shot next year.

10 It's -- if you had a new title, you know, there's
11 kind of that drafting effect, which you see in many of the
12 video game franchises. If you come out with Game X,
13 version 10, well, that means version 9, 8, 7, 6, 5, 4 and
14 previous ones will have a continued life span. But if you
15 don't, you don't.

16 So things were looking pretty severe by June.
17 The company attempted to try to shore things up, but by
18 August, it was clear, despite their best efforts, the
19 company was going to fail.

20 Q Scott, I'd like to turn to Exhibit 2. It's
21 page 7.

22 A Page?

23 Q On the PDF document, page 7. Let me know when
24 you have it.

25 A I'm scrolling as fast as I can. Yes, I have it.

1 Q And this is a letter that appears to be to you
2 from Ralph Bagley dated December 22, 2003. Are you
3 familiar with this?

4 A Yes, I am.

5 Q In this letter, Ralph Bagley stated you loaned
6 NSDI more than \$1.9 million; is that correct?

7 A Correct.

8 Q Now would that include several lending events --

9 A Yes, that would be a combination of all of the
10 original --

11 Q Okay.

12 A -- and then the line of credit and then the
13 short-term notes.

14 Q Okay. And he also states in the letter that he
15 had been forced to eliminate NSDI's entire staff; is that
16 your recollection of --

17 A Correct.

18 Q And that he would also be unable to repay the
19 loans you had made to NSDI; is that right?

20 A Correct.

21 Q Now when you received this letter, did you
22 believe your loans to be worthless?

23 A Yeah, unfortunately.

24 Q Okay. To your knowledge, did NSDI ever conduct
25 business or pay employees after 2003?

1 A Did not pay them -- did not have any employees
2 and did not pay anybody after 2003.

3 Q Okay.

4 A I can talk probably later, but I made the
5 decision as kind of the last person standing to not file
6 anything to derive the company into bankruptcy but rather
7 to detain it as a shareholder, and I asked Ralph Bagley to
8 retain the title of CEO even though he was not an employee
9 and was not going to be paid, for the simple reason that
10 the company had built up a certain reputation and he was
11 the face of the company.

12 He was the only person that the outside world
13 knew that represented N'Lightning. Also, the company had
14 about 100 and some odd thousand customers out there.
15 Ralph Bagley and Chris Perkins volunteered to continue to
16 provide technical support to customers for a period of
17 time -- I don't remember how long that went on, it was
18 quite some time -- without pay simply because it was the
19 right thing to do, and not having the customers who paid
20 and had bought games to be shortchanged on support.

21 Q Did you discuss the letter with anyone else?

22 A Sure, with Richard Berry, who is the financial
23 planner who did our taxes from Ayco Asset manager.

24 Q And what action did he suggest for providing this
25 letter?

1 A Well, his first question is was there any chance
2 these loans are going to be repaid and I said no. And as
3 evidenced or as stated in the letter, and then -- you
4 know, this is not something that I knew. And he said that
5 you have to take bad debt reductions in the year that you
6 know that it's a loss. You can't defer them or carry them
7 over or anything like that. So a bad debt write off would
8 have to have happened in 2003.

9 Q Did anyone else talk to Richard Berry with you
10 about this?

11 A Yeah. This was part of his -- he would, every
12 year at about that time, in September or thereabouts, he
13 would meet with my wife and I at our home and go over the
14 tax preparation requirements for that year, and then start
15 talking about planning for the succeeding year.

16 Q Do you believe he was a competent professional?

17 A Yeah. The how -- how that we came to use Richard
18 was the compensation committee and the board of directors
19 at Simer interviewed a number of firms and selected Ayco
20 Asset Management to provide financial planning and tax
21 services to the executives at the company as part of our
22 compensation package. So in specific then, once they had
23 selected Ayco, then Richard Berry was selected. So he not
24 only was taking care of my financial planning and tax
25 needs, he was all of the other executives at Simer as

1 well.

2 Q And did you provide everything he asked you to
3 provide in order to draft a return?

4 A I did.

5 Q And did you rely in good faith on his judgment,
6 what you should do with this letter and how you should
7 treat it on your tax returns?

8 A Yes.

9 Q And when did you ultimately claim the bad debt
10 deduction, which tax year?

11 A 2003.

12 Q Were you subsequently audited by the IRS?

13 A Yes.

14 Q What happened during that audit?

15 A Well, it first started that they just said, hey,
16 we have some questions. And it was several years later, I
17 don't recall exactly what the time frame, but then they
18 followed up and asked for a bunch of documentation, which
19 we provided. And then it was -- I had provided Ayco power
20 of attorney so the interaction was going between them and
21 the IRS office, but they would update me with phone calls
22 and whatever, e-mails. They were not -- they were leaving
23 messages and not being able to get anything back from the
24 person that was -- that was -- was reviewing the
25 information.

1 That person had sent a letter that said, okay,
2 here's how it goes, I'm going to ask for some
3 documentation and after I review it, I may ask for more
4 documentation, and then we will have a face-to-face
5 meeting. Well, that never happened, ever. There was
6 never a meeting between either Ayco or me or anybody else
7 directly with anyone at the IRS.

8 On the -- about the anniversary -- I don't know
9 if it was the first or second anniversary of their initial
10 request -- we were informed that the person was no longer
11 at the IRS. A new person was assigned, and I have no idea
12 how long they had that. They looked at what had been
13 provided, but they, you know, declined it and passed it
14 off to someone else for further review.

15 That led to a sequence of, you know, that -- it
16 is kind of hard to understand, but it passed through maybe
17 four or five different offices and a greater number of
18 individuals. Some of the things that I saw in the
19 correspondence back from Ayco to the various individuals
20 is they'd ask for information that had already been
21 provided or say that things had not been responded to when
22 they had.

23 At the end, we asked for documentation back from
24 the IRS when they had finished, and what they sent back
25 was a small fraction of what had been provided to them.

1 So I'm not sure, you know, exactly what went on. During
2 the course of this, I was advised by Ayco that there's two
3 routes you can take, one is an administrative review route
4 and the other is a legal route. And they said, you know,
5 this is a simple matter. You know, we have a pretty good
6 relationship with the IRS. This should be easily
7 resolved. We don't recommend -- they said -- you know, I
8 want to be concise. He said it's ultimately up to you,
9 but our suggestion is you don't need to go the legal
10 route, this can be resolved administratively and it will
11 be fine.

12 Q So to clarify, did you ever file a U.S. Tax Court
13 petition?

14 A No.

15 Q Was this upon the advice of your tax planner --

16 A Yes.

17 Q -- tax preparer?

18 A Yes.

19 Q Okay. I have no further questions at this time.
20 Scott, do you have anything you would like to add?

21 A No, I think we've basically covered it.

22 Judges, do you have any questions?

23 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you,
24 Mr. Scholler and Mr. Colabianchi. I'd like to check with
25 my panel members if they do have questions, and

1 Mr. Coutinho might have questions. I'd like to see first
2 if we have questions. If not, we will take a break right
3 now. If we do have questions, we will see -- maybe we
4 will take a question or two.

5 So Mr. Coutinho, do you have any questions for
6 this witness?

7 MR. COUTINHO: This is Brad Coutinho for
8 Respondent. No questions at this time. Thank you.

9 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you,
10 Mr. Coutinho.

11 Judge Akin, do you have any questions for
12 Mr. Scholler?

13 ADMINISTRATIVE LAW JUDGE AKIN: I do have one
14 question. I can try to keep it brief, but we can take a
15 break first if that's your preference.

16 ADMINISTRATIVE LAW JUDGE VASSIGH: Let me check
17 with Judge Kletter.

18 Judge Kletter, do you have any questions?

19 ADMINISTRATIVE LAW JUDGE KLETTER: I also just
20 have one brief question, so I'm happy to ask it before the
21 break or after.

22 ADMINISTRATIVE LAW JUDGE VASSIGH: So let's do
23 the questions now, and I'll go back to Judge Akin.

24 Please go ahead.

25 ADMINISTRATIVE LAW JUDGE AKIN: Sure. Okay.

1 Judge Akin speaking. So since we don't have the
2 promissory note in the record, I just wanted to verify one
3 potential term, it's regarding the interest. And if I
4 recall your testimony correctly, you said the interest was
5 to be accrued and then paid along with the loan and, you
6 know, once the company started bringing in sufficient
7 revenue is my understanding of your testimony. So did the
8 promissory note, did the term provide for that interest to
9 accrue or did it provide for periodic payments for the
10 interest maybe monthly or annually --

11 THE WITNESS: Yeah, it was to accrue. So when
12 you paid off one of the increments it was to be done FIFO,
13 first in first out. So in this case, the August one would
14 be whenever they paid it, it would be the accrual up to
15 that point in time plus the principal would be paid and
16 then you would move on to the next one.

17 ADMINISTRATIVE LAW JUDGE AKIN: Understood. And
18 that answers my question. That was all I had. Thank you.

19 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you,
20 Judge Akin.

21 Now we'll go to Judge Kletter.

22 ADMINISTRATIVE LAW JUDGE KLETTER: This is Judge
23 Kletter. I just have a question on how, I guess, you know
24 -- to recap my understanding, you mentioned that when the
25 January 2000 loan was -- you know, that original

1 \$400,00.00 to \$450,000.00 that was at a fairly high
2 interest rate to the company, and then the 2001 loan and
3 also the line of credit, those were at a lower interest
4 rate, and I was just wondering if you could explain why
5 those loans were at such a low interest rate, particularly
6 for the Home Valley Bank?

7 You had mentioned there was some interest rate
8 reductions over the course of that line of credit but you
9 just stepped in the shoes at that lower interest rate. So
10 just wondering --

11 THE WITNESS: So the interest rate on the line of
12 credit was what Home Valley Bank was charging. So they
13 were -- if you recall during that time frame, interest
14 rates were dropping like a stone, you know. I don't
15 remember where they started at, like, 9 percent or
16 something, and then 15 months later, they're, like, 2. So
17 the original was at a fairly high rate. Simply because
18 when the original loans were made, the company said they
19 were going to be able to bring out a product in nine
20 months.

21 That's a little bit incredulous because that
22 seemed like a pretty aggressive time frame. So they had
23 no track record, no product, no sales, so it's riskier.
24 Right? By the time that I agreed to make short-term
25 loans, interest rates were dropping, that's one thing.

1 The company had met its schedule and got its games out on
2 time. They were well received. They didn't have a lot of
3 bugs in them, and they were being reviewed well even by,
4 you know, what you might call secular reviewers, so you
5 know.

6 In any sort of startup, that debt financing is a
7 negotiation of what's fair to both parties, and certainly
8 while, you know, it wasn't as high interest rate as even
9 the Home Valley Bank thing, it was more than I was going
10 to make on it being in a savings account. So it seemed
11 fair to me and it's seemed fair to them. Does that answer
12 your question?

13 ADMINISTRATIVE LAW JUDGE KLETTER: This is Judge
14 Kletter. So that does answer my question. I do not have
15 any further questions. Thank you.

16 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay,
17 everyone, I'm going to ask you to mute your microphones
18 and turn off your video. My understanding is that the
19 live stream continues while we are on break. We will be
20 taking a 10-minute recess and going off the record.

21 Mr. Lopez from OTA might be checking in with some
22 of the new witnesses at this time. So please hold on for
23 a moment while he does that, and then we'll resume at
24 11:55.

25 (The morning recess was taken.)

1 ADMINISTRATIVE LAW JUDGE VASSIGH: Back on the
2 record.

3 MR. COUTINHO: I had a quick question in regards
4 to timing of the hearing. I know earlier you stated that
5 Appellant's witness testimony would go to 12:45 and then,
6 obviously, Respondent would have its argument, and then
7 Appellants' rebuttal; is that still the time frame?

8 ADMINISTRATIVE LAW JUDGE VASSIGH: I'm going to
9 add 10 minutes to account for the break we just took, so
10 Appellants have until 12:55. I realize they had seven
11 witnesses, so they will have to be very efficient with
12 their time, and then we will move to you for your
13 15-minute presentation, and Appellants will be given an
14 opportunity to present a rebuttal of five minutes.

15 I see that Ms. Maaske is with us, and I just want
16 to make sure we have Mr. Colabianchi. Can you let me know
17 if you are here?

18 MR. COLABIANCHI: Hi, your Honor. Yes, I'm here.

19 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you for
20 that pause. Actually, I was going to mention that. It
21 seems like we did have some overlap. In the transcription
22 efforts, it makes it a little difficult, so we are going
23 to try with the next witnesses. I want to remind everyone
24 to please give a tiny pause after a question has been
25 asked and then go ahead and answer the question.

1 Okay. We are ready, Mr. Colabianchi, for the
2 next witness. Who would you be calling?

3 MR. COLABIANCHI: Your Honor, I'd like to call
4 Gay Scholler.

5 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay.
6 Mrs. Scholler has been sworn in and she is under oath.
7 Please proceed when you're ready.

8 MR. COLABIANCHI: Thank you.

9
10 DIRECT EXAMINATION

11 BY MR. COLABIANCHI:

12 Q Hi, Gay. Good morning -- good afternoon where
13 you are, I believe.

14 A Good afternoon.

15 Q How long have you and Scott been married?

16 A For 44 years.

17 Q And Scott testified about N'Lightning. When did
18 you first hear about N'Lightning, was it from Scott or
19 otherwise?

20 A It was from Scott. I heard about N'Lightning in
21 the year 2000 when he said he wanted to give them a loan
22 for approximately \$850,000.00.

23 Q And after that, when he spoke to you about it,
24 did the two of you discuss whether you should loan and was
25 there a decision made?

1 A Yeah. We decided together to do that, yes.

2 Q And this was in 2000; is that right?

3 A Yes, it was.

4 Q Sorry. Okay. And after that time did you
5 discuss loans from you and Scott to NSDI at any other
6 point?

7 A I'm sure we did. I don't remember the specifics
8 on all that. He took care of all that. And so if he did
9 anything, he would run it by me and I probably said yes,
10 so that's all I have on that.

11 Q What happened to those loans?

12 A The loans that he made to them?

13 Q Correct.

14 A They didn't get paid. Is that what you mean?

15 Q Yes. And do you recall how much those loans were
16 for at the end?

17 A No, it was quite a lot, over a million dollars.

18 Q So it was more than the under \$850,000.00 that
19 was initially lent; is that correct?

20 A Yes, it was.

21 Q Okay. And then did you and Scott -- well, Scott
22 testified these loans were discussed with Richard Berry,
23 your tax preparer; is that correct?

24 A Yes, sir. Uh-huh. He came to our house every
25 year and he did an initial tax preparation. And the year

1 that it closed, he told us we need to take a loss off the
2 taxes of year that closed, which is 2003.

3 MR. COLABIANCHI: Okay. No further questions.
4 Thank you.

5 THE WITNESS: Thank you.

6 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you,
7 Mr. Colabianchi. Who will you be calling next?

8 MR. COLABIANCHI: Mr. Ralph Bagley.

9 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay. I would
10 like to double check. I believe Mr. Ralph Bagley was in
11 the first bunch of witnesses the was sworn in.

12 Is that correct, Mr. Bagley?

13 THE WITNESS: Yes, I'm here. And I have been
14 sworn.

15 ADMINISTRATIVE LAW JUDGE VASSIGH: You were sworn
16 in. Great. Just a reminder that you will remain under
17 oath until the end of this hearing.

18 I do want to go back to Mrs. Scholler. Sorry. I
19 wanted to make sure and see if Mr. Coutinho has any
20 questions for Mrs. Scholler?

21 MR. COUTINHO: This is Brad Coutinho. No further
22 questions. Thank you.

23 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay. Judge
24 Kletter, did you have any questions for Mrs. Scholler?

25 ADMINISTRATIVE LAW JUDGE KLETTER: No, I don't

1 have any questions.

2 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you.

3 And Judge Akin, do you have any questions for
4 Mrs. Scholler?

5 ADMINISTRATIVE LAW JUDGE AKIN: No questions.
6 Thank you.

7 ADMINISTRATIVE LAW JUDGE VASSIGH:
8 Mr. Colabianchi, you can proceed.

9 MR. COLABIANCHI: Thank you.

10

11 DIRECT EXAMINATION

12 BY MR. COLABIANCHI:

13 Q Good afternoon. Hi, Ralph. So let's see, Scott
14 testified that you were the founder and CEO of N'Lightning
15 Software Development, Inc; is that correct?

16 ADMINISTRATIVE LAW JUDGE VASSIGH: Mr. Bagley,
17 you can unmute yourself by pressing star 6.

18 THE WITNESS: Sorry about that. Yes.

19 BY MR. COLABIANCHI:

20 Q That was correct?

21 A Yes.

22 Q All right. Okay. Can you describe how, why, and
23 when NSDI was founded?

24 A Well, back in 1998 -- actually, I began work on a
25 -- I took some theology classes and began working on game

1 design, a very raw one, to provide a healthy alternative
2 to the games that were coming out at the time -- Doom,
3 Grand Theft Auto, these real violent games -- as a
4 high-quality alternative for people to play that wasn't
5 just all death and destruction and satanic imagery.

6 So once I got that done, I found some people here
7 in the Valley that I had had previous relationships with,
8 a couple of them were from my church, to go ahead and lend
9 me the money to get a demo done, it's called a vertical
10 slice in the gaming industry. It's just a very short
11 piece of game play with graphics and audio and scripted
12 game play that you can show people that this is what the
13 quality of the game is going to be.

14 So we did that, and then at that point we had the
15 tools we needed to go out and seek, you know, financing
16 for a company, to actually be a company, which was
17 considerably more, around \$900,000.00. And so I got in my
18 car and I had some appointments with some VC firms and I
19 went down to Menlo Park in the Bay Area and talked to some
20 VC people, and they quickly advised me equity financing
21 was not the way to go, that debt financing was really the
22 only option I had because we didn't have a company at that
23 point. We just had an idea.

24 And so I came back to talk to my team to create,
25 basically, a presentation, and then went out and started

1 talking to VC people again, and they recommended probably
2 angel investors would be the best way to go and so I began
3 asking people, especially in these VC companies, do you
4 know anybody, and that's how I actually met Scott was
5 through the gentleman, Russ Hall, and they had been
6 friends previously.

7 So he connected me with Scott and I was able to
8 meet with Scott and show him what we were doing, and then
9 not too far past that, you know, Scott called me and said,
10 hey, I think we can go ahead and do the loan for you.

11 Q You said Scott offered a loan for it. What was
12 the terms of that initial loan?

13 A I believe it was around \$850,000.00. I don't
14 have the exact numbers in my head. I'm just going by
15 memory here.

16 Q Yeah.

17 A It was to be done in two segments. The first
18 segment was \$400,000.00, and the second was \$430,000.00,
19 which was fine because, you know, we weren't just going to
20 use the whole \$850,000.00 off the bat. It was in the
21 business plan to get us in development and out into the
22 marketplace.

23 Q Okay. Scott has testified that NSDI established
24 an unsecured line of credit with Home Valley Bank in
25 September of 2000; is that your recollection as well?

1 A Yeah. So it's a good idea for really any
2 business to have a line of credit in case something
3 happens or you get an opportunity to pivot and move
4 quickly. We secured a \$400,000.00 credit line through
5 Home Valley Bank.

6 Q And what happened to this line of credit?

7 A Well, I mean, we were using it, and then I think
8 -- in fact, at one point they renewed it, and I don't
9 recall exactly when. And then after the renewal of the
10 loan, Home Valley Bank got bought out by another bank
11 called Banner Bank, and Banner didn't issue credit lines,
12 and so they notified us with very short notice and said,
13 hey, you know, this loan is -- we are going to close it
14 down.

15 And so I went into scramble mode and I believe we
16 tried meeting with some other banks, and it would have
17 been months to get that thing approved, and so I went to
18 Scott and I said, hey, you know, this is the crunch we are
19 in, if we don't have this line of credit, it's going to be
20 really hard, especially to grow in the marketplace because
21 we were using that for inventory and marketing and things
22 like that, and Scott basically went ahead and just took
23 over the credit line. So instead of dealing with Home
24 Valley Bank, we had a credit line with Scott.

25 Q Would it be fair to say that Scott stepped into

1 the shoes of the bank?

2 A Yeah. That would be the best way to say it,
3 actually.

4 Q Let's see. Scott has testified that in 2001,
5 NSDI obtained commitments from him to provide a series of
6 short-term loans in addition to the already \$850,000.00
7 he had loaned. So this is 2001; is that correct?

8 A Yes.

9 Q And this was -- was this before he stepped into
10 the shoes of Home Valley Bank?

11 A Boy, I think we had that -- the unsecured line of
12 credit with Home Valley Bank, I believe, was in fall of
13 2000 that we initially established it. I'm trying to just
14 remember real quick here. I think they renewed the line
15 of credit, Home Valley Bank did, the following year, the
16 fall of 2001. And then shortly thereafter, like, spring
17 of 2002, is when they told us that they wouldn't renew it
18 because -- I remember it was, like, June, that was the
19 deadline, and you know - and that was in May.

20 Q Going back to the short-term loans that began in
21 2001 from Scott, what were the circumstances surrounding
22 these loans and why did NSDI need them?

23 A Well, we had -- our sales were actually
24 improving, and we had created Catechumen and Ominous
25 Horizons, and we were really needing to launch these

1 things into the marketplace and there was a lot of
2 expenses that we didn't realize that we would have to do
3 to get into some of the major retailers. We had talked
4 with Target and Game Stop, and they had agreed to carry
5 our products, but they needed marketing materials and end
6 cap materials and, obviously, they needed a certain level
7 of inventory available.

8 We had to -- you know, back then, games were on
9 the shelf, so we had to purchase the boxes and the
10 wrapping and the disks, and so we needed cash, and so
11 that's why I approached him.

12 Q Okay. And was there a board meeting or anything
13 similar that discussed the short-term loans that NSDI
14 would be procuring from Scott?

15 A Yes, we had board meetings basically for every
16 major decision.

17 Q And was there -- were there board meeting minutes
18 that were produced?

19 A Yes, there were. From every meeting there were
20 board minutes produced.

21 Q And what do you think happened to those minutes?

22 A Well, I know exactly what happened to them. A
23 few years later, after the business had closed and we had
24 a lot of this stuff just in storage, the records were on a
25 pallet in the warehouse underneath a skylight. Well, we

1 had a massive snow storm, probably the biggest snow storm
2 I've ever had -- and I've been in the Valley for over 20
3 years -- and this skylight in the warehouse collapsed in
4 and ruined the -- I think it was six pallets of our stuff
5 and one of the pallets it ruined had our records on there,
6 you know, because was all paper records.

7 It was buried in a massive pile of snow that then
8 melted on top of them and all of those papers were
9 basically mush, and they were already several years old.
10 And so, you know, I thought that there was a seven-year
11 statute of limitations and so at that point I wrote it off
12 and said, well, these are not salvageable, and we tossed
13 them.

14 Q Do you recall the terms of the short-term loans
15 with Scott?

16 A Oh, I mean, I don't recall the exact terms, it's
17 been over 20 years, but I know the basic terms were, when
18 we received the loans, that our sales would increase and
19 we had a plan to do that, to increase sales in 2003, and
20 that was going really well, until you know, we found out
21 we had been embezzled. And at that point everything kind
22 of caved in and we weren't able to meet sales that we had
23 hoped.

24 A lot of it too, I remember you know we had had
25 to pivot from the youth groups, which was a big deal with

1 us. And I remember in -- September 11, 2001, I was in the
2 airport in Portland, actually in the airport when the
3 first plane hit that tower in New York, and I was flying
4 out that day to meet with 600 youth pastors at a
5 convention that Youth for Christ organized. Obviously,
6 they shut the airport down and the conference ended up
7 getting canceled because nobody could fly to it, and that
8 was a major wound in our marketing program because we had
9 to go back and redo everything and try to -- you know, and
10 we had missed the window, and so it put a real onerous
11 position for us as we went into -- you know, 2002 was a
12 year where we didn't achieve our sales goals because we
13 had to pivot and kind of react to what happened with 9/11.

14 Q Mr. Bagley, do you have the proposed exhibits
15 that I submitted? It would be Exhibit 17. I believe I
16 sent them in an e-mail to you.

17 A I do.

18 Q Okay. Could you please turn to Exhibit 17? It's
19 statement of financial position.

20 A Yes. Hold on here. Page what?

21 Q In the PDF I sent you, it would be page 33.

22 A Hold on. Bear with me. Okay. I got it.

23 Q Great. And what is this document? It says
24 N'Lightning Software Development, Inc., statement of
25 Financial Position. What is it?

1 A It's actually not the one I brought up. Hold on.
2 Okay. I got it. Okay. It is a P & L and balance sheet
3 that was created that details out what the liabilities and
4 assets we had at the time.

5 Q What was the context for the creation of this
6 document? Was it attached to another document?

7 A No. I actually found this when I was looking for
8 our official release date. It was in a sound asset folder
9 that it shouldn't have been in, and so when I found it, I
10 went, oh, and this is something that I just recently
11 discovered.

12 Q Okay. And to clarify, is this a printout of an
13 Excel file that you found?

14 A Yes.

15 Q Okay. Let's go to line 28. It says Long-term
16 Debt.

17 A Yes.

18 Q Is it says Notes payable stockholder
19 \$1.5 million. Do you know what that number represents?

20 A That's the loan amount that he had given us up to
21 that point, yes.

22 Q When you say he, you are talking about Scott
23 Scholler?

24 A Yes. Sorry.

25 Q If you go above a little bit, it's line 22,

1 Accrued Interest Stockholder. Is that related to that
2 note payable?

3 A Oh, yeah. Yeah, in the year --

4 Q And then below that -- okay. Sorry about that.

5 A The agreement -- you know he had -- we had agreed
6 to pay interest in the shares in the company too.

7 Q And then below that you have Line of Credit
8 Refinanced by Stockholder. Is that the Home Valley Bank
9 line of credit?

10 A Yes, it is.

11 Q And then there's also interest on that refinanced
12 correct below that?

13 A Yes.

14 Q Okay. I'd like to talk now about the end of life
15 of NSDI.

16 A Okay.

17 Q So Scott has testified that he wasn't repaid or
18 if he was repaid, it was a very small amount for these
19 loans. Scott mentioned Michael Acton, how did his actions
20 affect the business?

21 A This guy. He was hired as our CFO, and he had,
22 you know, all of the credentials. We went ahead and hired
23 him and he was a piece of work. He would come in and pray
24 with us in the morning and then go in and figure out ways
25 to steal from us.

1 I didn't realize what was happening until 2003,
2 our sales were actually growing, but we had no money in
3 the account and I was perplexed, so I took the weekend and
4 just went through all of the documentation I had, and that
5 Monday morning I remember I went to the bank and asked for
6 printouts of all the checks, and that's when I caught him.
7 What he was doing was showing myself and the board fake,
8 like, quarterly tax returns.

9 He would inflate the number to us and then write
10 himself a check for the difference. And sometimes he
11 wouldn't even pay the IRS, he would just keep the whole
12 amount. So when I caught him, obviously, I went to the
13 police immediately after I documented all of the checks
14 that he had basically forged, and they charged him with
15 embezzlement of \$115,000.00 initially, but dropped down to
16 \$102,000.00 because there was a few thousand dollars that
17 we couldn't prove.

18 Q Did his embezzlement have a direct effect on NSDI
19 closure?

20 A Oh, man, it was catastrophic. It was almost a
21 full quarter of money we needed that was gone or missing,
22 so that really hurt us. And then on top of that, all of
23 the work that I was doing to market the games and get them
24 out there, I had to stop and deal with this legal thing
25 because I had to go through the whole set of books since

1 Michael Acton had been there and identify each and every
2 instance and talk with the police about it. It was
3 catastrophic.

4 Q Scott Scholler has testified that NSDI closed
5 down not long after that and had to let go of its
6 employees; is that correct?

7 A Yes, unfortunately.

8 Q And do you recall what year that was?

9 A It could have been 2003, I think, late summer,
10 early fall, somewhere in there.

11 Q Could you please turn to -- these would be the
12 previous -- not in the proposed exhibits, the main
13 exhibits on OTA's file. Let me see it. I think page 34
14 of 68 for Exhibit 4. If you have the whole PDF, it would
15 be page 45.

16 A Okay. This is the hearing binder and exhibits?

17 Q Yes -- yeah.

18 A Sorry.

19 Q Actually, if you could go to page 46 please on
20 the PDF.

21 A Got it. I'm here.

22 Q Great. So this an account transcript from the
23 IRS?

24 A Yes.

25 Q And this -- let's see -- are you familiar with

1 payroll taxes -- are you familiar with the payroll taxes
2 that were part of the compliance with tax law?

3 A Yes.

4 Q And this says, Tax Period June 30, 2003, and it
5 says there was a tax return filed September 1st, 2003.
6 Does that generally comport with your recollection?

7 A Yes, it does.

8 Q And it also says that there was \$9,600.00 worth
9 of payroll tax paid for this period, it would have been
10 April, May -- excuse me. It would have been April, May,
11 June period, so that implies there were employees in that
12 quarter; is that correct?

13 A Yes.

14 Q Okay. And let's go to the next page, please. It
15 would be page 36 of 69.

16 A Okay.

17 Q And this is the same account transfer IRS form
18 941, the tax period ending September 30, 2003, that would
19 include July, August, September, was the tax return filed?

20 A No because that's when everybody, basically, was
21 laid off.

22 Q Could you go to the next page, please.

23 A Okay.

24 Q And this is for the fourth quarter of 2003, there
25 was also no tax return filed. Do you remember it that

1 way?

2 A Yep.

3 Q So for the rest of this exhibit there are no tax
4 returns filed. In fact, it says requested data not found.
5 This goes to the end of 2009. Did NSDI ever have payroll
6 after 2003?

7 A No.

8 Q Okay. Exhibit 2, please, would be page 6 in that
9 same PDF.

10 A Okay.

11 Q Actually, page 7. This is a letter from you to
12 Scott. Do you recognize this document?

13 A Oh, yeah. This was very a painful one for me to
14 write.

15 Q Okay. You stated that Scott Scholler had loaned
16 NSDI more than \$1.9 million; is that correct?

17 A Yes.

18 Q And that NSDI would been unable to repay Scott;
19 is that correct?

20 A Yes, at that time it was quite clear.

21 Q Why didn't the business file for bankruptcy?

22 A Well, you know, when I first started this, part
23 of the reason that Scott was a very attractive option for
24 us, he understands this wasn't just about making money.
25 We wanted to provide a high-quality, faith-based

1 alternative out in the marketplace, and we did that.

2 These games have great -- they still have really
3 good reviews from people that play them even though
4 they're over 20 years old now, you know. And we wanted to
5 set an example and, you know, there are so many so-called
6 Christian businesses that, you know, they don't operate as
7 a Christian business. They say they are, but they don't,
8 so we didn't want to be that.

9 And Scott is one of the guys that I've known in
10 my life now that has integrity, and so we both agreed that
11 we would do whatever it took if we could to pay off
12 anybody we owed and not stiff them, and so that was the
13 whole reason that, you know, we wanted to make sure we
14 paid everybody off so they couldn't say that we were
15 hypocrites.

16 Q Could Scott have initiated an action to recover
17 the loans or attempt to recover the loans?

18 A I don't see how. We had no assets. I mean --
19 there was nothing we could do.

20 Q So would you say that if he had done something
21 like that it would have been futile?

22 A Yeah. I mean, we had no money.

23 Q Okay.

24 MR. COLABIANCHI: All right. No further
25 questions.

1 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you for
2 your testimony, Mr. Bagley. I'm asking you to stay with
3 us while we go to Mr. Coutinho to see if he has any
4 questions.

5 THE WITNESS: I apologize about my camera not
6 working, but at lease the microphone works.

7 ADMINISTRATIVE LAW JUDGE VASSIGH: That's the
8 important part.

9 MR. COUTINHO: This is Brad Coutinho. I have no
10 questions.

11 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you.
12 I'd like to ask Judge Akin, do you have any questions for
13 Mr. Bagley?

14 ADMINISTRATIVE LAW JUDGE AKIN: Thank you. Yes,
15 I do have one question.

16 Mr. Bagley, you testified that all of the
17 employees were laid off, you know, summer of 2003. Can
18 you describe what, if any, operations the company had
19 after that? Do you know of any in 2003 and after June and
20 then in any subsequent years?

21 THE WITNESS: Well, I mean, the only operations
22 we actually had was just tech support for our customers.
23 You know, we -- again, we had close to 100,000 games out
24 there that people had purchased and I didn't want them to
25 be out there with no support and so I volunteered, along

1 with Chris Perkins, to take care of that tech support by
2 phone or e-mail when we could, and then we did it. I
3 think it went on for several years after that.

4 ADMINISTRATIVE LAW JUDGE AKIN: Okay. Thank you.

5 And just one follow-up question. Was there any
6 continued sales of products, you know, after approximately
7 June 2003 and in subsequent tax years or any continued
8 development of new games after that?

9 THE WITNESS: There was no continued development
10 of new games. We did try to contract out with some people
11 the might hire us but none of it panned out. But as far
12 as, you know, sales, it had gone down to trickle. We did
13 have a few units in the warehouse that we ended up
14 donating to Campus Crusades for Christ and some other
15 organizations. So the answer really is no. If it was, it
16 was very, very minimal. Anything we did get, we paid off
17 our vendors with.

18 ADMINISTRATIVE LAW JUDGE AKIN: Okay. Thank you.
19 That's all of my questions.

20 ADMINISTRATIVE LAW JUDGE VASSIGH: And I have no
21 questions, so we are almost ready to move on to the next
22 witness. I do want to note that we will be factoring in
23 question-and-answer time in determining the Appellants'
24 remaining time allotment, Mr. Colabianchi. You don't have
25 a lot of time, and you have several witnesses on the list.

1 So who will you be calling next?

2 MR. COLABIANCHI: Your Honor, can you remind me,
3 when is my time over at this point?

4 ADMINISTRATIVE LAW JUDGE VASSIGH: Your time
5 would be over at 12:55. I'm going to add another three
6 minutes to that for the question-and-answer portion, so
7 12:58.

8 MR. COLABIANCHI: Okay. I would like to call
9 Dave Caputo, please.

10 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay.

11 Mr. Caputo has not yet joined the meeting.

12 MR. COLABIANCHI: Okay. If Chris Perkins is
13 here, then I could call him.

14 ADMINISTRATIVE LAW JUDGE VASSIGH: I'm hearing
15 that Mr. Caputo has joined. Let's give it just a second
16 and see. I'm waiting for confirmation from the team.
17 They meant Mr. Perkins is in there.

18 Mr. Perkins, you have been sworn in already.

19 Mr. Colabianchi, proceed when you are ready.

20 MR. COLABIANCHI: Thank you.

21

22 DIRECT EXAMINATION

23 BY MR. COLABIANCHI:

24 Q Hi, Mr. Perkins. Let's see, Ralph Bagley
25 testified that you were the project lead at NSDI; is that

1 correct?

2 ADMINISTRATIVE LAW JUDGE VASSIGH: Mr. Perkins,
3 go ahead and press star 6 to unmute yourself.

4 THE WITNESS: I'm sorry. I thought I had already
5 pressed that. My apologies. Yes, that is correct, I was
6 the project lead at N'Lightning.

7 BY MR. COLABIANCHI:

8 Q And briefly, what does that mean?

9 A Well, I was in charge of the programmers, the
10 artists, and the sound people, just making sure we have a
11 cohesive product and delivering it on time.

12 Q So do you have a copy of your declaration or are
13 you familiar with it? It would be exhibit --

14 A I'm familiar with it.

15 Q -- Exhibit 10. Okay. Great.

16 A And I do have a copy of it.

17 Q And you stated that in this declaration that
18 Scott Scholler would provide NSDI a series of loans; is
19 that correct?

20 A That is correct.

21 Q Do you recall when this was?

22 A Boy, I think right up front, right in the
23 beginning and through the process especially toward the
24 end of the first one and beginning of second and maybe the
25 end of the second. It's been a while so I apologize.

1 Q It's been over 20 years so it's understandable.
2 How did you become aware that Scott would be providing
3 these loans?

4 A Ralph Bagley kept the team informed. We had our
5 Friday meetings, I believe, in the afternoon. Ralph was
6 good at keeping everyone informed. It was important for
7 all of us to know where we stood on everything.

8 Q Do you recall when you became involved with NSDI?

9 A I want to say June of '99, something like that,
10 right at the -- right at the beginning.

11 Q Okay. And in your declaration you state that
12 Scott would be paid back when sales began to pick up. How
13 optimistic was NSDI and you that sales would pick up and
14 you would be able to repay these loans?

15 A Well, you know, we actually had a pretty good
16 product for the day. We were pretty optimistic, honestly.
17 Realistically, sales should have been much, much better.
18 We just had issues with the Christian book sellers wanting
19 anything to do with video games for whatever reason. We
20 were optimistic.

21 Q And let's see, did you -- you stated to keep our
22 staff limited so we would be able to repay these loans,
23 was that your recollection? Were you constrained in any
24 way because of this concern that NSDI would have to repay
25 the loans later?

1 A Constrained? I know, yes, I played a small part
2 in coming up with the budget and telling the management
3 what was needed as far as staffing and, yes, as things got
4 tight, we had to do some cutbacks.

5 Q Okay. And then what caused NSDI to shut down and
6 when was this, to your recollection?

7 A Well, I don't remember the year, but it was a
8 while after our second title, and it was Mike Acton who
9 was the controller, I believe was his title, and embezzled
10 somewhat over \$100,000.00 over the course of a couple
11 years he was there. That's enough to take any small
12 business down.

13 Q And then after NSDI shut down, did you have any
14 continued involvement with it?

15 A I stayed on unpaid for -- I don't know -- six
16 months or a year. I can't remember. I did tech support.
17 I would field e-mails and phone calls from customers who
18 were having technical issues with our game. Yeah.

19 Q Well, thank you Mr. Perkins. I have no further
20 questions.

21 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you for
22 your testimony, Mr. Perkins. I'm asking you to stay with
23 us as we go to Mr. Coutinho to see if he has any questions
24 for you.

25 MR. COUTINHO: This is Brad Coutinho. No

1 questions at this time. Thank you.

2 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you.

3 Judge Kletter, do you have any questions at this
4 time?

5 ADMINISTRATIVE LAW JUDGE KLETTER: This is Judge
6 Kletter. No questions. Thank you.

7 ADMINISTRATIVE LAW JUDGE VASSIGH: Judge Akin, do
8 you have any questions?

9 ADMINISTRATIVE LAW JUDGE AKIN: This is Judge
10 Akin. I don't have any questions. Thank you.

11 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay.

12 Mr. Colabianchi, who will you be calling next?

13 MR. COLABIANCHI: If Mr. Caputo has entered then
14 I can call him, otherwise, I can call Mr. Detrick.

15 ADMINISTRATIVE LAW JUDGE VASSIGH: It looks like
16 Mr. Caputo is not here today on this call, so let's bring
17 Mr. Detrick in.

18 Mr. Colabianchi, I just want to let you know the
19 number that was provided for Mr. Caputo is not correct so
20 OTA has not been enable to reach him. Would you like to
21 take a two-minute recess and contact Mr. Caputo?

22 MR. COLABIANCHI: We could or I could see if
23 Scott might be able to contact him. Scott should still be
24 here, yeah.

25 ADMINISTRATIVE LAW JUDGE VASSIGH: Mr. Scholler,

1 can you do that please? If you are interested in having
2 him. Okay. I'm being told there was a mistake.
3 Sometimes we don't see everything on the screen. So we
4 will move forward with Mr. Detrick.

5 Mr. Detrick, I will need to swear you in so we
6 can consider your testimony as part of the record, and you
7 will remain under oath until the end of this hearing.

8 Can you please raise your right hand?

9 THE WITNESS: Can you hear me now.

10 ADMINISTRATIVE LAW JUDGE VASSIGH: I can hear
11 you?

12
13 DOUG DETRICK,
14 having been first duly sworn, was examined and testified
15 as follows:

16
17 THE WITNESS: Yes.

18 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you.

19 Mr. Colabianchi, please proceed.

20 MR. COLABIANCHI: Thank you.

21
22 DIRECT EXAMINATION

23 BY MR. COLABIANCHI:

24 Q Good afternoon, Mr. Detrick.

25 A Hello.

1 Q So Ralph Bagley testified that you were a member
2 of NSDI's board of directors; is that correct?

3 A Correct.

4 Q Are you familiar with your declaration? It would
5 be Exhibit 9.

6 A I am.

7 Q Okay. You stated that you participated in
8 telephonic board meetings in 2001 where Scott Scholler
9 offered to loan money to NSDI; is that correct?

10 A That is correct.

11 Q And you say that the loan was to be up to
12 \$400,000.00 but that amount appeared to be optimistically
13 low. Did you recall how much Scott ultimately loaned
14 NSDI?

15 A No, I don't know the exact amount, but it was
16 probably more than double than that.

17 Q Were these incremental loans as needed by NSDI
18 according to your recollection?

19 A They were.

20 Q Do you recall any other terms of the loans?

21 A I don't. I don't.

22 Q Okay. Thank you.

23 You mentioned in your declaration there were two
24 factors that contributed to the end of NSDI. The first
25 factor was lower-than-expected sales. Can you tell me a

1 little bit about that briefly?

2 A Yes. I mean, I got involved because I had met
3 Ralph and -- and I wouldn't typically get involved in
4 something like that, but when he explained to me the
5 market and that this market was needing these kinds of
6 things, I got excited about it. And my only concern was
7 how good the game was, and as it ended up -- it ended up
8 it was a great game, because I actually played it.

9 I never played a video game before, and I loved
10 the game. The sales -- to answer your question, the sales
11 weren't doing well because a number of reasons, the market
12 just wasn't -- it was hard to penetrate a market that
13 wasn't used to using games. And distribution is also --
14 it doesn't matter what business you are in, distribution
15 is always a problem.

16 This was a startup, and getting the word out
17 there was a very difficult thing, and it took time to
18 build. And then finally in the end, I mean, it just kept
19 taking more and more money to continue to get the things
20 to go. And in the end, the accountant -- I can't --
21 Michael Acton took a bunch of money and that was it.

22 Q And what happened to NSDI after Mr. Acton
23 embezzled from the company?

24 A That was the end of it.

25 Q And when did you leave NSDI board of directors?

1 A August of 2003.

2 Q Thank you, Mr. Detrick. No further questions.

3 A Okay. Thank you.

4 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you.

5 I'm going to ask you to stay with us for a moment,
6 Mr. Detrick, while I check if anyone has any question for
7 you.

8 Mr. Coutinho, do you have any questions for
9 Mr. Detrick?

10 MR. COUTINHO: This is Brad Coutinho. No
11 questions. Thank you.

12 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you.

13 Judge Kletter, do you have any questions for
14 Mr. Detrick?

15 ADMINISTRATIVE LAW JUDGE KLETTER: This is Judge
16 Kletter. No questions.

17 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay.

18 Judge Akin, do you have any questions for
19 Mr. Detrick?

20 ADMINISTRATIVE LAW JUDGE AKIN: No questions from
21 me. Thank you.

22 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay.

23 Mr. Colabianchi, I want to let you know that it
24 appears that Dave Caputo has joined the hearing room.
25 Mr. LaBelle is not in the hearing room, so if you would

1 like him present, maybe Mr. Scholler can give him a call.
2 It sounds like the number listed for Mr. LaBelle was not
3 correct. Mr. Colabianchi, would you like to move forward
4 with your next witness?

5 MR. COLABIANCHI: Yes, with Mr. Caputo, please.

6 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay. So
7 let's make sure he's entered. Just keep in mind I'm being
8 told that Dan Hilderbrand is also present.

9 MR. COLABIANCHI: Great.

10 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay. I
11 believe we have Mr. Caputo with us now. Can you press
12 star 6 to unmute and just confirm that you are Dave
13 Caputo? We are looking for Dave Caputo. So I see a
14 Dave's phone on the screen, and if that is Dave Caputo,
15 please press star 6 to unmute yourself and confirm that
16 that is you. Okay. For whatever reason he doesn't seem
17 available right now.

18 Mr. Colabianchi, would you like to move on to
19 your next witness?

20 MR. COLABIANCHI: Yes, I think he said that Dan
21 Hilderbrand was here.

22 THE WITNESS: I'm sorry. Can you hear me?

23 ADMINISTRATIVE LAW JUDGE VASSIGH: Yes. Is this
24 Mr. Caputo?

25 THE WITNESS: It is. It wasn't star six. This

1 is the first time on Zoom on the phone, so you will have
2 to excuse my ignorance.

3 ADMINISTRATIVE LAW JUDGE VASSIGH: That's okay.
4 We can hear you loud and clear. I'm going to swear you
5 in, and you will remain under oath until the end of this
6 hearing. Can you please raise your right hand.

7
8 DAVE CAPUTO,
9 having been first duly sworn, was examined and testified
10 as follows:

11
12 THE WITNESS: I do.

13 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you.

14 Mr. Colabianchi, please proceed.

15 MR. COLABIANCHI: Thank you.

16
17 DIRECT EXAMINATION

18 BY MR. COLABIANCHI:

19 Q Good afternoon, Mr. Caputo. Thank you for being
20 available. Are you familiar with your declaration that
21 you submitted? It's labeled Exhibit 8.

22 A I am.

23 Q Great. Okay. Ralph Bagley testified you were
24 the director of marketing and sales at NSDI; is that
25 correct?

1 A That is correct.

2 Q And do you recall when you were in that position?

3 A It was early 2000s. I believe I left N'Lightning
4 in the fall of 2003, if memory serves me correctly.

5 Q Okay. And now I'm going to refer you to your
6 declaration. You stated that NSDI finances were tight.
7 How familiar were you with NSDI's financial situation?

8 A Well, I mean, as far as financial situations,
9 anything that I did as far as marketing and sales, I would
10 submit a proposal and that would have to be approved from
11 the board of directors before we could act on it. So as
12 far as money, you know, I knew there was certainly a
13 limited amount of financing that was available, so
14 anything that I, you know, suggested or a direction we
15 went, it would have to be approved.

16 Q Okay. You also stated that Scott Scholler would
17 provide NSDI a series of loans; is that correct?

18 A That is correct.

19 Q How did you become aware that Scott would be
20 providing these loans?

21 A Well, Ralph came to me where I was presently
22 working in Tampa, Florida and Ralph came to me and told me
23 what his plan was and asked me if I would be interested in
24 a position and I state I would consider it only after he
25 secured financing.

1 He had stated there again, he was in the process
2 of working on financing, and at a later time he contacted
3 me and said he had secured financing from a gentleman by
4 the name of Scott Scholler. At that point I agreed to
5 come out to southern Oregon to lead off the marketing and
6 sales for N'Lightning.

7 Q Did Scott provide any further financing past that
8 point?

9 A Amounts, I couldn't tell you; however there were
10 multiple, multiple times things would get tight and Ralph
11 would have to go back and secure additional financing
12 through Scott.

13 Q Okay. And to your knowledge was there a -- well,
14 in your declaration you said there was a loan instrument
15 memorializing the arrangement; is that your recollection?

16 A Could you define memorializing, please?

17 Q Was there a promissory note or a loan agreement
18 that you were aware of with Scott?

19 A I mean, if you ask me, you know, I knew that
20 there was an agreement, however, had I, you know, seen
21 that agreement, I don't recollect seeing it. And Ralph
22 would, you know, inform us as far as what he had secured
23 and what we had to work with.

24 Q And then, briefly, when NSDI closed down, what
25 were the reasons and when did that happen?

1 A Well, on my part, I actually left before they
2 closed down. They were in the process of doing that. The
3 money had just -- the finances ran out. There was no more
4 financing to be had. Obviously, it was hamstringing any
5 marketing or sales proposals that I had to propose to try
6 to accomplish what I was tasked to accomplish so I went
7 ahead and left N'Lightning and went to work for another
8 company.

9 Q Do you recall which year that was?

10 A I want to say I left N'Lightning, like I said
11 before, I want to say -- again, going back 20 years ago, I
12 want to say fall of 2003.

13 Q Okay. All right. Thank you, Mr. Caputo. No
14 further questions.

15 A Thank you.

16 ADMINISTRATIVE LAW JUDGE VASSIGH: Mr. Caputo,
17 please stay with us for a few more minutes while I check
18 to see if anyone has any questions for you.

19 Mr. Coutinho, do you have any questions for this
20 witness?

21 MR. COUTINHO: This is Brad Coutinho. No
22 questions at this time.

23 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you.

24 Judge Kletter, do you have any questions for
25 Mr. Caputo?

1 ADMINISTRATIVE LAW JUDGE KLETTER: This is Judge
2 Kletter. No questions.

3 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you.
4 Judge Akin, do you have any questions for
5 Mr. Caputo?

6 ADMINISTRATIVE LAW JUDGE AKIN: Thank you. No
7 questions from me.

8 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay. And
9 there are no questions from me. Thank you very much,
10 Mr. Caputo.

11 Mr. Colabianchi, would you like to call your next
12 witness?

13 THE WITNESS: Excuse me, am I all finished?
14 Sorry for the interruption.

15 ADMINISTRATIVE LAW JUDGE VASSIGH: If you are
16 able to stay in the waiting room just in case there are
17 follow-up questions, that would be helpful.

18 THE WITNESS: All right.

19 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you very
20 much.

21 Mr. Colabianchi?

22 MR. COLABIANCHI: If Mr. LaBelle is available,
23 I'd like to call him. If not, I'd like to call
24 Mr. Hilderbrand.

25 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay. I'm

1 checking with our staff to see if Mr. LaBelle is
2 available. Okay. It looks likes right now we have only
3 Mr. Hilderbrand in the waiting room, so let's bring
4 Mr. Hilderbrand in. I see his name here.

5 Good afternoon, Mr. Hilderbrand.
6 Mr. Hilderbrand, can you hear me? He seems to have me on
7 mute. If someone could give Mr. Hilderbrand a quick call
8 that would be appreciated.

9 Let's go on to quick break just to allow -- it
10 looks like Mr. Scholler is actually calling
11 Mr. Hilderbrand. So we will take a two-minute break and
12 hopefully Mr. Scholler can get Mr. Hilderbrand up to -- so
13 he can participate. So let's take two minutes. If
14 everyone will go off the record and if everyone can please
15 turn off your video and turn off your audio as the live
16 stream does continue.

17 (There was a pause in the proceedings.)

18 ADMINISTRATIVE LAW JUDGE VASSIGH:

19 Mr. Hilderbrand, thank you for raising your right
20 hand.

21
22 DAN HILDERBRAND,
23 having been first duly sworn, was examined and testified
24 as follows:

25 THE WITNESS: I will.

1 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you very
2 much.

3 Mr. Colabianchi, please proceed when you are
4 ready.

5 MR. COLABIANCHI: Thank you.

6
7 DIRECT EXAMINATION

8 BY MR. COLABIANCHI:

9 Q Good afternoon, Mr. Hilderbrand. Thanks for
10 being available. I would like to direct you to
11 Exhibit 13. This is your sworn statement. Are you
12 familiar with this document?

13 A Yes, sir, I am.

14 Q Are you the president of CC Complete?

15 A I am, and chief operating officer.

16 Q Could you briefly explain what CC Complete is,
17 what kind of business it is?

18 A We are a software service. We write applications
19 and host them on our own equipment and then we charge our
20 customer base to access and use this very
21 specifically-designed software and applications.

22 Q Could you briefly explain how Scott Scholler is
23 related to CC Complete?

24 A Scott Scholler was one of the original founders
25 of CC Complete in 1995 or '94 or something like that, and

1 was a -- he is a primary stockholder in the company and
2 CEO of CC Complete.

3 Q According to your letter, you state that CC
4 Complete wired money to N'Lightning at the direction of
5 Mr. Scholler. Could you please briefly explain the
6 circumstances surrounding those wires why CC Complete did
7 this?

8 A I can. Now this happened before my time, and so
9 what I had to do is have our accountant go back and review
10 the accounting records. I joined in early 2002, but for
11 the safe and expediency is our understanding that in lieu
12 of the company sending money to Scott, he asked that he
13 transfer monies over to him to N'Lightning, and that was
14 the foundation of those transfers.

15 Q Great. And no further questions. Thank you.

16 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you for
17 your testimony, Mr. Hilderbrand. I'm going to ask you to
18 stay with us for a few moments. I'd like to see if
19 Mr. Coutinho has any questions.

20 MR. COUTINHO: This is Mr. Coutinho. No
21 questions at this time.

22 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay.

23 Judge Kletter, do you have any questions for
24 Mr. Hilderbrand?

25 ADMINISTRATIVE LAW JUDGE KLETTER: This is Judge

1 Kletter. I just had one quick question for
2 Mr. Hilderbrand.

3 You said that you joined in early 2003; is that
4 correct?

5 THE WITNESS: 2002.

6 ADMINISTRATIVE LAW JUDGE KLETTER: Sorry. 2002.
7 Okay.

8 Could you please explain the relationship between
9 CC Complete and N'Lightning, specifically with the Mike
10 Acton and Bill Blenbo and what the relationship between
11 the two companies were and why those employees were sent
12 to N'Lightning?

13 A So Acton was the controller of the company when I
14 came on board. He didn't last very long after I got
15 there, but he was controller and he also served as, I
16 believe, controller for N'Lightning. But mind you, I
17 don't have a lot of information about N'Lightning. Other
18 than it was one of Scott's entities he was involved in,
19 and Acton served as a dual role working for CC Complete
20 and for N'Lightning as a controller.

21 ADMINISTRATIVE LAW JUDGE KLETTER: And was Bill
22 Blenbo also a CC Complete employee?

23 THE WITNESS: No, I was never familiar with Bill
24 Blenbo at CC Complete.

25 ADMINISTRATIVE LAW JUDGE KLETTER: Okay. No

1 further questions. Thank you.

2 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you,
3 Judge Kletter.

4 Judge Akin, do you have any questions for
5 Mr. Hilderbrand?

6 ADMINISTRATIVE LAW JUDGE AKIN: Thank you. No
7 questions from me.

8 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay.

9 Mr. Hilderbrand, I just want to ask for some
10 clarification on your testimony. You testified that you
11 were not at the company when CC Complete provided funds or
12 transferred funds to N'Lightning. Can you reiterate for
13 us how you came to that information and did you personally
14 see records that led you to this claim?

15 THE WITNESS: Yes, I personally saw records.
16 What I had was our then accountant go back and look at all
17 of the transfers to Scott or on Scott's behalf and went
18 through and did a complete -- not audit, but an exhibit to
19 show me exactly those transactions in the records that
20 were in the accounting files. So there's a ledger that
21 records every one of those disbursements to Scott or on
22 his behalf.

23 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay. Thank
24 you.

25 THE WITNESS: And the bank account corroborates

1 that by the way.

2 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you,
3 Mr. Hilderbrand. And I believe that we have no more
4 questions for you, so if you don't mind staying in the
5 Zoom in the waiting room, that would be helpful, in case
6 there are later questions.

7 THE WITNESS: Okay. So I'll just mute and --

8 ADMINISTRATIVE LAW JUDGE VASSIGH: Yes, and you
9 can turn off your video.

10 Okay. Mr. Colabianchi, I'm being told that
11 Mr. LaBelle is in the waiting room. So would you like to
12 call him next? You have a couple minutes.

13 MR. COLABIANCHI: Yes, please. I would like to
14 call Mr. LaBelle.

15 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay. So if
16 this is Chris LaBelle, can you please press star 6 or
17 otherwise unmute yourself and let me know that you are
18 here? I see Mr. Chris LaBelle's name. Can you please let
19 us know that you are here and that you can hear me? So
20 Mr. LaBelle, if you are joining us not through a phone but
21 through Zoom, you might have to click unmute, the bottom
22 left of the your screen. And if you are calling in, you
23 would press star 6.

24 MR. LA BELLE: Can you hear me now?

25 ADMINISTRATIVE LAW JUDGE VASSIGH: We can hear

1 you.

2 MR. LA BELLE: I apologize. Let's move forward.
3 What can I do for you?

4 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay. Great.
5 So first of all, I would like to confirm your name,
6 please.

7 MR. LA BELLE: Chris LaBelle.

8 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay. Great.
9 I'm going to ask you to raise your right hand so I can
10 wear you in and you will be under oath until the end of
11 this hearing today.

12
13 CHRIS LA BELLE,
14 having been first duly sworn, was examined and testified
15 as follows:

16
17 MR. LA BELLE: Yes.

18 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay.

19 Mr. Colabianchi, please proceed.

20 MR. COLABIANCHI: Thank you.

21

22 DIRECT EXAMINATION

23 BY MR. COLABIANCHI:

24 Q Good afternoon, Mr. LaBelle. Thanks for being
25 available. How do you know Ralph Bagley and NSDI?

1 A We were co-tenants at a building or warehouse at
2 727 N. Central Avenue, Medford, Oregon.

3 Q What kind of items was Ralph storing at the
4 warehouse?

5 A To my knowledge, he had software -- gaming and
6 software, games, things of that nature.

7 Q Could he have been storing documents and business
8 records there?

9 A Highly possible. It seems like most of his
10 operation was there.

11 Q What happened to those items?

12 A To my knowledge, there was a -- well, I remember
13 there was a very large, extremely heavy snow event. The
14 roof at the warehouse is pretty flat. It's a pitched roof
15 but it's flat, and it failed in many spots. I remember
16 the landlord had to basically replace the whole roof. And
17 so a lot of water -- I had some water damage, and I know
18 that Ralph did as well.

19 Q You said you had some water damage. How badly
20 were your products damaged?

21 A It depends on where it was with us. A lot of my
22 cases -- I'm a beverage distributor so a lot of my cases
23 are in flats of cardboard, and I had to repack a lot of
24 cases into new cardboard cases because of the amount of
25 water that came through in various spots.

1 Q Great. No further questions. Thank you?

2 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you.

3 Thank you, Mr. LaBelle, if you can stay with us
4 for a moment. I'm just going to check and see if anyone
5 has any questions about your testimony.

6 Mr. Coutinho, do you have any questions?

7 MR. COUTINHO: This is Mr. Coutinho. No
8 questions at this time.

9 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you.

10 Judge Kletter, do you have any questions?

11 ADMINISTRATIVE LAW JUDGE KLETTER: This is Judge
12 Kletter. No questions. Thank you.

13 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you.

14 Judge Akin, do you have any questions?

15 ADMINISTRATIVE LAW JUDGE AKIN: No questions from
16 me. Thank you.

17 ADMINISTRATIVE LAW JUDGE VASSIGH: And I also
18 have no questions, so thank you, Mr. LaBelle. If you
19 don't mind staying in the waiting for a bit just in case
20 questions come up later, that would be helpful. Okay.

21 I just want to check in with the judges to see if
22 there are questions for any of the witnesses who have
23 testified so far today.

24 Judge Akin, do you have any other questions for
25 witnesses at this point?

1 ADMINISTRATIVE LAW JUDGE AKIN: No additional
2 questions from me at this point.

3 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you.

4 Judge Kletter, do you have any questions for any
5 of the witnesses at this point?

6 ADMINISTRATIVE LAW JUDGE KLETTER: Yeah, I do not
7 have any additional questions. Thank you, Judge Vassigh.

8 ADMINISTRATIVE LAW JUDGE VASSIGH: And I'll
9 double check with Mr. Coutinho, do you have any questions
10 for any of the witnesses at this point?

11 MR. COUTINHO: This Mr. Coutinho. No questions
12 at this time. Thank you.

13 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay. And in
14 that case, Mr. Coutinho, we are ready for your
15 presentation. You will have 15 minutes. Please begin
16 when you are ready.

17 MR. COUTINHO: Give me one second to pull up my
18 documents and I'll be ready.

19 ADMINISTRATIVE LAW JUDGE VASSIGH: Sure.

20 MR. COUTINHO: My name is Brad Coutinho and I
21 represent Franchise Tax Board in this matter. There are
22 three main issues in this appeal. The first is that
23 Appellants have not shown that the proposed assessment
24 which is based on federal adjustments is erroneous.

25 Specifically, Appellants have failed to provide

1 consistent information and documentation demonstrating
2 they're entitled to a non-business bad debt deduction
3 claimed for the 2003 tax year.

4 The second issue is that Appellants have failed
5 to show that the accuracy-related penalty should be
6 abated.

7 And the third issue is that Appellants are not
8 entitled to interest abatement because Appellants
9 significantly contributed to the error or delay during the
10 protest by failing to note Respondent when their federal
11 audit concluded.

12 To the first issue. In this case, Franchise Tax
13 Board assessed additional tax based on federal information
14 which reflected that the IRS disallowed non-business bad
15 debt deduction. Appellants' federal account transcript
16 and audit file do not reflect that the federal adjustments
17 were ever revised or abated.

18 In regards to the non-business bad debt
19 deduction, income tax deductions are a matter of
20 legislative grace and the taxpayer who claims the
21 deduction has the burden to maintain records that are
22 sufficient to establish that amount of that deduction.

23 Internal Revenue Code Section 166, to which
24 California comports to, allows a deduction for a business
25 or non-business debt that has become worthless during the

1 tax year. There are two sub-issues in regard to the
2 non-business bad debt deduction. First, whether there was
3 a bona fide debt and, second, whether the debt became
4 worthless during the 2003 tax year.

5 To the first sub-issue, there is no bona fide
6 debt because there was no formal loan instruments. Two,
7 there is nothing that reflected a lender-borrower
8 relationship. And three, the economic realities of the
9 transaction would not have been taken on by a prudent
10 outside lender.

11 To the first sub-point, the form of the
12 instrument. The absence of any type of formality
13 typically associated with a loan, such as a loan
14 agreement, a promissory note, or demand for payment
15 supports the conclusion that the advances were
16 contributions to capital rather than a loan.

17 Appellants alleged that due to a winter storm,
18 embezzlement by a former employee, and a hard drive crash,
19 there are no promissory notes, no board minutes, and no
20 financial statements from the 2003 tax year, no loan
21 repayment schedule, no contemporaneous e-mail exchanges,
22 or any other formal loan documents to reflect a bona fide
23 debt.

24 Instead, Appellants have provided several
25 witnesses and testimony from Appellants to establish that

1 the loans existed; however, courts upheld that
2 uncorroborated oral testimony is insufficient to satisfy
3 the taxpayer's burden in an equity versus debt
4 determination.

5 Today, Appellants have demonstrated some of the
6 difficulties of relying on uncorroborated oral testimony.
7 For instance, during his testimony, Mr. Bagley testified
8 that the sales of NSDI's video games were actually growing
9 in 2003, while Appellant Husband has testified that the
10 company was beginning to show signs of stress in early
11 2003.

12 Moreover, in his testimony today, Appellant
13 Husband seems to elude to the fact that the payments of
14 loan would only occur when the company was on sound
15 financial footing with no definitive dates, which seems
16 contrary to the nature of the short-term loan.

17 Further, as stated today during his testimony,
18 Appellant Husband is a sophisticated business person, he
19 has served as an investor for four separate companies,
20 some of which have become IPOs and are still in business
21 today. As a sophisticated investor and businessperson,
22 Appellant Husband knew or should have known the importance
23 of keeping proper recordkeeping, especially considering
24 this loan of over \$1.2 million.

25 If Appellant Husband intended for those funds to

1 be repaid, he had an obligation to maintain records that
2 reflected payment schedules, promissory notes, board
3 minutes, or demands for repayments.

4 There's nothing in the record that reflects after
5 one of the unfortunate events that occurred such as the
6 embezzlement, such as the snow storm, such as the hard
7 drive crash, that Appellants took any action to
8 reconstruct or request declarations to corroborate the
9 loans provided by NSDI. The lack of formal documents,
10 including a promissory note and more importantly, any
11 demands for repayment, reflect that the funds provided
12 were not loans.

13 To the second sub issue, intent of the parties.
14 In Appellants' reply brief dated April 25, 2002,
15 Appellants state that there were two lending events as
16 they have stated today. The first lending event was a
17 loan of over \$800,000.00 that was made in the year 2000,
18 and that was to be repaid one year later.

19 The second lending event were short-term loans
20 which comprised the non-business bad debt deduction that
21 are at issue in this appeal. There is nothing in the
22 record that reflects that the first lending event resulted
23 in a repayment of the loan. There's also no demand for
24 repayment regarding the first lending event.

25 Despite the lack of repayment of the first loan,

1 Appellant Husband proceeded in 40 separate transactions
2 over a two-year period to distribute \$1.2 million to NSDI.
3 There's no indication that Appellants ever requested
4 repayment, requested that the terms of the agreement be
5 amended, or that any of NSDI's assets be immediately
6 liquidated to repay the loan.

7 Given the lack of evidence reflecting repayment
8 in the demand for repayment, it is fair to assume that
9 neither party intended that the funds be repaid at the
10 time the funds were issues.

11 To the third sub issues, economic realities. In
12 this case the economic realities reflects that a prudent
13 outside lender would not have entered into the same
14 arrangement that Appellant Husband did with NSDI. As
15 explained earlier and to reiterate, Appellant Husband made
16 an initial loan of \$800,000.00 that appears to have never
17 been repaid, yet Appellant Husband allegedly proceeded to
18 loan another \$1.2 million in several transactions over a
19 two-year period despite no evidence that the funds would
20 or could be repaid by NSDI considering the defaults of the
21 initial loan.

22 No prudent lender would have continued to advance
23 contributions when the business entity repeatedly and
24 continuously defaulted on the terms of the reported loans.

25 Based on a lack of formal loan documents, the

1 lack of intent by the parties, and the repeated defaults
2 by NSDI, there was no bona fide debt and thus, the IRS
3 properly disallowed the non-business bad debt deduction
4 for the 2003 tax year.

5 To the second sub issue, Appellants have not
6 demonstrated that the debt became worthless in 2003.
7 Appellants bear the burden of proof to show that the
8 purported loans became worthless in the 2003 tax year. To
9 determine whether a debt is wholly or partially worthless
10 is based on all facts and circumstances including the
11 financial condition of the debtor.

12 In Bishop V. Commissioner, a U.S. Tax Court case,
13 the court found the testimony alone is insufficient absent
14 documentary evidence to corroborate that the debt has
15 become worthless. For example, the Bishop Court stated
16 the while the lender himself may have concluded that the
17 debt had become worthless, there was no financial and cash
18 flow statements or earning reports that would corroborate
19 the lender's conclusion in the Bishop case.

20 Similarly, while Appellants may have taken
21 Mr. Bagley's September 22, 2003 letter to conclude that
22 the debt had become worthless, there are no financial
23 statements from 2003 tax year, no cash flow projections,
24 no earnings report that support Appellants' conclusion.

25 The record also reflects that the debt did not

1 become worthless until much after 2003. Exhibit L to
2 Respondent's reply brief dated March 17, 2021, reflects
3 that NSDI did not dissolve until late 2009, six years
4 after Mr. Bagley's letter.

5 Exhibit M to Respondent's reply brief reflects
6 several articles where Mr. Bagley touts NSDI's success,
7 and more importantly, that the demand for Christian video
8 games and the potential growth for years to come.
9 Specifically, there is a question and answer interview
10 with Mr. Bagley that is dated July 19, 2005, that can be
11 found on Exhibit M, page 22.

12 In that question and answer, there is a question
13 regarding the Christian game business. In response to
14 that question, Mr. Bagley states that Christian game
15 business is outstanding. My team is currently negotiating
16 with a few different Christian authors to do games based
17 on their books. Those would be \$4 to \$6 million projects.

18 There is a subsequent article in the LA Times
19 dated May 10, 2006, that is attached to Exhibit M. At the
20 very end of page 18 of Exhibit M, there is a line that
21 states "Bagley saw demand for his games skyrocket during
22 last year's holiday season," presumably the December 2005
23 holiday season.

24 Moreover, Mr. Bagley even touted the past success
25 of NSDI in the investor presentation and the financial

1 statement provided in Exhibit 16, page 7 by Appellants.
2 In that financial statement it shows that the company has
3 sufficient assets to pay all or some of the alleged loans
4 owed to Appellant Husband. As testified Mr. Bagley today,
5 the sales of the company were growing in 2003. As
6 testified by Appellant Husband, instead of demanding
7 repayment after receiving Mr. Bagley September 2003
8 letter, he instead decided to have the company continue
9 on, presumably so that him and Mr. Bagley could eventually
10 return to the company to sound financial footing.

11 The continuation of NSDI for multiple years,
12 Mr. Bagley's statements about the future prospects of
13 Christian video games, and Appellants' lack of demand for
14 repayment, and lack of recordkeeping, all demonstrate the
15 debt could not be considered worthless by the end of the
16 2003 tax year.

17 To the second issue regarding the
18 accuracy-related penalty. During the pre-hearing
19 conference, Appellants stated that they were not
20 contesting the computation or imposition of the
21 accuracy-related penalty, but rather assert that a
22 accurate-related penalty should be abated in conjunction
23 with withdraw of the proposed assessment.

24 Today, Appellants allege that the
25 accuracy-related penalty should be abated due to a

1 reliance on a financial advisor, but conceive that they
2 have no documentary evidence to support this contention.
3 As explained in its opening brief, Respondent followed the
4 IRS's imposition of the accuracy-related penalty for a
5 substantial understatement of tax, and there is no
6 evidence in the record to support the abatement of the
7 accuracy-related penalty nor withdrawal of Respondent's
8 proposed assessment.

9 To the third issue regarding the interest
10 abatement. Appellants have failed to establish that they
11 are entitled to an abatement of interest of the proposed
12 assessment because they significantly contributed to the
13 delay from the issuance of the Notice of Proposed
14 Assessment in 2009 to when the Notice of Action was issued
15 in 2010.

16 As reflected in Exhibit G on page 5 of
17 Respondent's opening brief, in Appellants' protest letter,
18 they requested that the matter be deferred based on a
19 pending matter with the IRS related to the proposed
20 assessment. During the deferral period Respondent
21 followed up with Appellants on multiple occasions but the
22 record reflects that Appellants never responded.

23 Due to Appellants' initial request for deferral
24 and a subsequent nonresponse to FTB's letters related to
25 federal matter, Appellants significantly contributed to

1 the error or delay and thus interest cannot be abated
2 under California Revenue and Taxation Code Section 19104.

3 In conclusion, based on the evidence and in the
4 record, Appellants have provide inconsistent
5 non-contemporaneous documentation that fails to meet its
6 burden to establish that they're entitled to the
7 non-business debt deduction claimed for the 2003 tax year.
8 As such, Respondent's proposed assessments should be
9 sustained. I'm happy to address any questions or concerns
10 the Panel may have at this time.

11 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you,
12 Mr. Coutinho. I'll check with my panelists if they have
13 any questions.

14 Judge Akin, do you have any questions for FTB?

15 ADMINISTRATIVE LAW JUDGE AKIN: Judge Akin
16 speaking. I do have one question.

17 Mr. Coutinho, I understand FTB's position is both
18 that it's not a bona fide debt and also that it was not
19 worthless in 2003. On the first of those positions, if it
20 is not a bona fide debt, what is FTB's position as to what
21 these contributions, assuming they were made, what are
22 they?

23 MR. COUTINHO: It appears from the first loan
24 that there was some equity that was given to Appellant
25 Husband, I believe it was 20 percent as testified to

1 today. It appears from the letter that was dated in
2 September of 2003 from Mr. Bagley that essentially
3 Appellant Husband would then be the owner of the
4 corporation based off the debt that had been accrued. So
5 it appears that there may have been equity.

6 Based off the testimony today, it appears that
7 they were not loans based off the lack of demands for
8 repayments, and that the company was going to continue on
9 and pay other vendors instead of Appellant Husband, so it
10 could potentially just be Appellant Husband believing in
11 the company and hoping from a -- as he testified today, as
12 a parent, that hopefully would succeed and potentially
13 penetrate a larger market than it had.

14 ADMINISTRATIVE LAW JUDGE AKIN: Okay. And as
15 follow up, I guess, I'm wondering if it's not a bona fide
16 debt, if it would be additional paid in capital or equity
17 to which IRC Section 165(g) would apply? Again, this
18 would be -- I'm not addressing the issue of when it become
19 worthless. I understand your position on that. I wanted
20 to address whether or not this could be potentially, if
21 not a debt, an equity interest to which IRC 165(g) would
22 apply.

23 MR. COUTINHO: Give me one second.

24 ADMINISTRATIVE LAW JUDGE AKIN: Absolutely.

25 MR. COUTINHO: As stated in the Respondent's

1 additional brief dated November 18, 2022, Appellants have
2 not shown that they qualify as a capital loss on IRC
3 Section 165(g), specifically they haven't provided any
4 evidence of any stock certificates, any registered
5 security that would reflect that he received the stock
6 purchase from this. Second, there is a lack of adjusted
7 basis, again, to the inconsistent statements regarding the
8 loan amounts and when it was provided.

9 And then third, I think more importantly it
10 appears that a condition to qualify that the security
11 became worthless -- I understand that's not quite your
12 question, it was more just whether the first two, but as
13 stated earlier, Respondent's position is that the security
14 did not become worthless in 2000. Thank you.

15 ADMINISTRATIVE LAW JUDGE AKIN: Understood. I
16 do understand your position on that and I don't mean to
17 short change you on it. My question wasn't to that, but
18 that answers my question. Thank you for that. I don't
19 have any additional questions.

20 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you,
21 Judge Akin.

22 Judge Kletter, do you have any questions at this
23 time?

24 ADMINISTRATIVE LAW JUDGE KLETTER: I do not have
25 any questions for FTB.

1 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay.

2 Mr. Colabianchi, would you like to make a final
3 statement rebuttal to FTB's presentation?

4 MR. COLABIANCHI: Hi, your Honor, this is
5 Mr. Colabianchi. I did want to address a couple points
6 here. So Mr. Coutinho said that the form of the
7 instrument was not there for it to be a bona fide debt and
8 that uncorroborated witness testimony is not enough.

9 While I agree that we don't have a copy of the
10 promissory note or the meeting minutes where these loans
11 were discussed, we do have testimony from multiple
12 witnesses that corroborate each other, and we also have
13 contemporaneous records that were provided, notably the
14 profit and loss statements, showing that these loans were
15 being treated as loans in the internal company records.

16 Then Mr. Coutinho also discussed the intent of
17 the parties and that there was no demand for repayment.
18 The problem with that is that Scott knew that a demand
19 such as this would be futile, and that the only assets
20 remaining in the company in 2003, one that was worthless,
21 were -- was game stock that would be difficult for Scott
22 to get any funds out of.

23 Mr. Coutinho mentioned the economic reality and
24 he said that no outside lender would provide loans to the
25 company when, in fact, the company did have an outside

1 lender, it was Home Valley Bank, and this was
2 contemporaneous with when Mr. Scott Scholler was providing
3 these short-term loans and the Home Valley Bank line of
4 credit was 2000, it was renewed in 2001.

5 From 2001 to 2002, the interest rate was being
6 lowered consistent with the market interest rate, and then
7 it was finally canceled in 2002, June, but unrelated to
8 their specific client because they had been bought out by
9 a different bank and didn't want to offer that product
10 anymore. But Scott's loan started in 2001, so
11 contemporaneous with Scott's loan, there was an outside
12 vendor providing funds to NSDI.

13 As far as worthlessness, Mr. Coutinho says that
14 it can't be based on testimony alone, but we do have
15 several objective indicators, we have the embezzlement of
16 Mr. Acton corroborated in Exhibit 3 talking about the
17 embezzlement, we have witnesses corroborating that event,
18 and we have IRS records showing that the business had
19 payroll in 2003, and then in the beginning of 2003 and
20 then toward the later part, they didn't, and then the rest
21 from 2003 to 2009, there's no payroll. So it's a strong
22 indicating that the business was defunct.

23 Mr. Coutinho mentioned that the business was not
24 technically dissolved until 2009. We think this is just
25 an administrative task that wasn't completed by Mr. Bagley

1 and really is not very significant when compared to the
2 payroll tax records which are more on the ground of
3 something that, you know, if you are not paying payroll
4 tax, you probably don't have employees.

5 The articles that Mr. Coutinho mentioned, some of
6 them are misleading. I think a lot of it is more
7 aspirational on Mr. Bagley's part. And then, for example,
8 they mentioned something about the Left Behind series, but
9 NSDI never had a contract with Left Behind. There are
10 some inaccuracies in the article that are noted in my
11 briefs.

12 As far as the penalty, this is an
13 accuracy-related penalty, and my clients relied on their
14 professional, both Gay and Scott have testified to that.
15 And I think it's reasonable to see Mr. Bagley's letter
16 dated in 2003, and say, well, if a tax professional looked
17 at that, this debt that he's referring to he's saying is
18 worthless now in 2003, so it needs to be declared on the
19 taxes, I think that would be a reasonable position to
20 uphold, and their reliance on the tax preparer was
21 reasonable as well.

22 As for the interest, while it is true that
23 Mr. Scholler was trying to get an audit reconsideration
24 with the IRS and had asked the Franchise Tax Board for
25 more time, it seems the last time that Franchise Tax Board

1 checked in with him was in 2016, several years after he
2 had already filed the protest. And so it seems like even
3 at that point it was seven years after the protest, but
4 Franchise Tax Board waited another four years with no
5 contacts to issue the Notice of Action, so we do feel that
6 that interest should be abated. And if we have any more
7 time, I would like to see if Scott might have anything to
8 add as well.

9 ADMINISTRATIVE LAW JUDGE VASSIGH: We are
10 actually out of time. So I'm going to check my
11 co-panelists and see if they have any final questions for
12 yourself or for Franchise Tax Board or any of the
13 witnesses today.

14 Judge Kletter, do you have any questions?

15 ADMINISTRATIVE LAW JUDGE KLETTER: This is Judge
16 Kletter. No questions.

17 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay.

18 Judge Akin, do you have any questions?

19 ADMINISTRATIVE LAW JUDGE AKIN: I think I just
20 want to ask one quick question. So I asked Franchise Tax
21 Board if it's not a bona fide debt whether it could
22 potentially be a worthless security pursuant to IRC
23 Section 165(g), and I just want to give Appellants an
24 opportunity to respond to that same question.

25 MR. COLABIANCHI: Thank you, your Honor. Well,

1 our position has consistently been that it's a bad debt
2 deduction. And my client is no longer a California
3 resident, so the capital loss would, in this sense, would
4 not be useful. I know that's not a legal argument, but
5 the practicalities of it.

6 There was a brief, and I do believe if you follow
7 it, there's some factors that are similar between the bad
8 debt deduction and the worthless securities, the
9 worthlessness is the same analysis, and obviously, we
10 think it was worthless in 2003.

11 Whether it was the security -- there was, I
12 believe Mr. Coutinho said that there was funds for
13 security that was in the first loan that wasn't actually
14 considered in the calculation of the bad debt deduction.
15 We do think there's an argument to be made it could be a
16 worthless stock capital loss, but it doesn't really help
17 my client, and then I think he could say that it was a
18 worthless stock if it's not going to be a bad debt
19 deduction. I don't know how deeply you need to me to go
20 into it, but I think it could be, yes.

21 ADMINISTRATIVE LAW JUDGE AKIN: You answered my
22 question. I do understand that's your primary position is
23 that it's a bona fide debt and you know a bad debt
24 deduction is under IRC Section 166. I just wanted to give
25 you an opportunity to respond to the same question I had

1 asked and you addressed it, so no further questions for
2 me. Thank you.

3 MR. COLABIANCHI: Thank you, your Honor.

4 ADMINISTRATIVE LAW JUDGE VASSIGH: Okay. And I
5 have no questions either. So I'm going to now go to a
6 procedural matter and check with Mr. Coutinho. I don't
7 know if you have decided whether you would like to provide
8 any post-hearing briefing on Exhibit 16, 17, and 18?

9 MR. COUTINHO: Yes, I would like to provide --
10 this is Mr. Coutinho. I would like post-hearing briefing.

11 ADMINISTRATIVE LAW JUDGE VASSIGH: Thank you.
12 And in that case, we will grant that and the record will
13 be held open until next Friday for additional briefing on
14 the issue of proposed Exhibits 16, 17, and 18, following
15 additional briefing -- yes, Mr. Coutinho.

16 MR. COUTINHO: Can I just -- one week?

17 ADMINISTRATIVE LAW JUDGE VASSIGH: How much time
18 do you need?

19 MR. COUTINHO: Can I have -- can I get a month or
20 two weeks --

21 ADMINISTRATIVE LAW JUDGE VASSIGH: I can do two
22 weeks. We can do two weeks because this is -- you know,
23 they're last minute exhibits.

24 MR. COUTINHO: Okay.

25 ADMINISTRATIVE LAW JUDGE VASSIGH: So we will

1 hold the record open for two weeks, two Fridays from now,
2 for additional briefing on the issue of proposed
3 Exhibit 16, 17, and 18. Following the additional briefing
4 period, OTA will close the record in this appeal and OTA
5 will issue a written opinion within 100 days thereafter.

6 This is the last appeal of the day, so this
7 hearing is adjourned and this concludes the hearing
8 calendar for today. Thank you to everybody who provided
9 arguments and testimony, and thank you to Ms. Maaske for
10 our stenography work today, and thank you to the OTA team
11 who has been working so hard behind to scenes. Have a
12 good day.

13 (The hearing was concluded at 1:37 p.m.)
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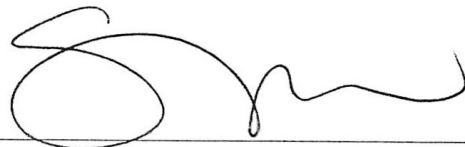
1 HEARING REPORTER'S CERTIFICATE

2
3 I, Shelby K. Maaske, Hearing Reporter in and for
4 the State of California, do hereby certify:

5 That the foregoing transcript of proceedings was
6 taken before me at the time and place set forth, that the
7 testimony and proceedings were reported stenographically
8 by me and later transcribed by computer-aided
9 transcription under my direction and supervision, that the
10 foregoing is a true record of the testimony and
11 proceedings taken at that time.

12 I further certify that I am in no way interested
13 in the outcome of said action.

14 I have hereunto subscribed my name this 14th day
15 of October, 2024.

16
17
18 

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20 _____
21 Shelby Maaske,
22 Hearing Reporter
23
24
25

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