

BEFORE THE OFFICE OF TAX APPEALS
STATE OF CALIFORNIA

IN THE MATTER OF THE APPEAL OF,)
)
A. Brayton,) OTA NO. 21037435
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CERTIFIED COPY

TRANSCRIPT OF ELECTRONIC PROCEEDINGS
State of California
Tuesday, September 17, 2024

Reported by:
CHRISTINA RODRIGUEZ
HEARING REPORTER

Job No. :
50607OTA(B)REV

1 APPEARANCES:

2
3 Administrative Law Judge: KEITH LONG
4 NATASHA RALSTON
5 VERONICA LONG
6

7
8 For the Appellant: A. BRAYTON
9 R. SPIES
10

11
12 For the Respondent: STATE OF CALIFORNIA
13 FRANCHISE TAX BOARD
14
15 KAMALPREET KHAIRA
16 MATTHEW MILLER
17
18
19
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25

1 I N D E X

2
3 E X H I B I T S

4
5 (Department's Exhibits A-S were admitted by the
6 Administrative Law Judge.)

7 P R E S E N T A T I O N

8 PAGE

9 By Mr. Tucker 11

10 By Ms. Khaira 44

11
12 C L O S I N G S T A T E M E N T

13
14 By Mr. Canestrelli 56

15
16 FOR THE APPELLANT:

17 A. BRAYTON:

18 Direct Examination by Mr. Tucker: 16

19 Cross-Examination by Ms. Khaira: 25

20 Redirect Examination by Mr. Canestrelli: 30

21 R. SPIES:

22 Direct Examination by Mr. Canestrelli: 31

23 Cross-Examination by Ms. Khaira: 41

1 Remote Proceedings; Tuesday, September 17, 2024

2 2:30 p.m.

3
4
5 JUDGE LONG: We are opening the record in the
6 Appeal of Brayton. The OTA Case No. is 21037435. This
7 matter is being held before the Office of Tax Appeals.
8 Today's date is September 17th, 2024, and the time is
9 approximately 2:30 p.m. This hearing is being convened
10 electronically.

11 Today's hearing is being heard by a panel of
12 three administrative law judges. My name is Keith Long,
13 and I will be the Lead Administrative Law Judge. Judge
14 Veronica Long and Judge Natasha Ralston are the other
15 members of this tax appeal panel. All three judges will
16 meet after the hearing and produce a written decision as
17 equal participants.

18 Although I will conduct the hearing, any judge
19 on this panel may ask questions or otherwise participate
20 to ensure that we have all of the information needed to
21 decide this appeal. As a reminder, the Office of Tax
22 Appeals is not a Tax Court, it is an independent
23 appeals body.

24 The panel does not engage in ex parte
25 communications with either party. OTA will issue an

1 opinion based on the parties' arguments, the admitted
2 evidence, and the relevant law.

3 As a further reminder, since it's been a few
4 minutes since we started, today's hearing is being live
5 streamed. So anything that you say or display on screen
6 will be seen on the internet, and we do request that you
7 don't use the chat function within Zoom.

8 For the record, will the parties please state
9 their names and who they represent, starting with the
10 representatives for Appellant.

11 MR. CANESTRELLI: Hi. I'm Pietro Canestrelli,
12 and I represent Appellant, Alan Brayton.

13 MR. TUCKER: Good afternoon. I'm Justin
14 Tucker, and I represent Alan Brayton.

15 MS. KHAIRA: Good afternoon. I'm Kamalpreet
16 Khaira. I represent Respondent, Franchise Tax Board.

17 MR. MILLER: Good afternoon. My name is
18 Matthew Miller, and I represent Respondent, Franchise
19 Tax Board.

20 JUDGE LONG: Thank you. There is one issue in
21 this appeal, and that is whether Appellant has
22 established that he is entitled to deduct his pro rata
23 share of a bad debt deduction.

24 My understanding is that we have two witnesses
25 today. At the prehearing conference and then

1 Appellant's prehearing conference statement, Appellant
2 indicated that their witnesses would include Alan
3 Brayton and Richard Spies.

4 As a reminder, witness testimony is not
5 required from oral hearing; however, testimony given
6 under oath may be considered as evidence. Additionally,
7 FTB is given the opportunity to cross-examine any
8 witnesses.

9 Would Appellant please confirm that it will
10 present testimony -- witness testimony in this hearing.

11 MR. CANESTRELLI: Yes, confirmed.

12 JUDGE LONG: Thank you. I will take the
13 witness affirmations now.

14 Mr. Brayton and Mr. Spies, would you please
15 raise your right-hands. Mr. Spies, you'll have to
16 un-mute for this one.

17 Do you swear or affirm to tell the truth, the
18 whole truth, and nothing but the truth?

19 MR. BRAYTON: I do.

20 JUDGE LONG: I'm sorry. I'm not sure which
21 person answered on that one:

22 MR. CANESTRELLI: Mr. Brayton answered.

23 JUDGE LONG: Mr. Brayton. And, Mr. Spies, I
24 couldn't hear you.

25 Do you swear or affirm to tell the truth, the

1 whole truth, and nothing but the truth?

2 It appears that your microphone is not
3 working. Can't hear you. It may be that your
4 microphone is muted on the computer as -- instead of
5 just on the Zoom program. Now, it's muted on the Zoom
6 program as well.

7 Mr. Spies, we're going to take a quick pause
8 in the hearing. We'll take five minutes, and someone
9 from OTA will reach out to you and help you with your
10 microphone.

11 In the meantime, we're going to go off the
12 record.

13 (Off the record.)

14 JUDGE LONG: We are back on the record.

15 Mr. Spies, lets start from the beginning here.

16 Would you please raise your right-hand. Do
17 you swear or affirm to tell the truth, the whole truth,
18 and nothing but the truth.

19 MR. SPIES: I do.

20 JUDGE LONG: Thank you. You may lower your
21 hand.

22 All right. Moving forward to exhibits. At
23 the prehearing conference and Appellant's prehearing
24 conference statement -- wait. That's the wrong line.
25 The exhibits for this appeal consists of FTB Exhibit's

1 A through S.

2 At the prehearing conference, Appellant had no
3 objections to these exhibits. Mr. Canestrelli,
4 Mr. Tucker, would you please confirm that there are no
5 objections at this time.

6 MR. CANESTRELLI: No objection.

7 MR. TUCKER: No objection.

8 JUDGE LONG: FTB Exhibits A-S are admitted
9 with no objections.

10 (Department's Exhibits A-S are admitted
11 into evidence.)

12 JUDGE LONG: After the prehearing conference,
13 Appellant timely provided an exhibit index identifying
14 Exhibits A through J. FTB received those -- received the
15 exhibits in the format that OTA received them today just
16 before this oral hearing. It has not yet had time to
17 review them.

18 As discussed with the attorneys from FTB,
19 there are no objections at this time; however, because
20 FTB has not had time to review the exhibits, they will
21 be given 30-days of the date of this oral hearing to
22 file any objections with OTA.

23 Appellant will be given 30 days after that to
24 respond to objections, and a decision will be made on
25 the exhibits at that time.

1 Mr. Miller, Ms. Khaira, is that your
2 understanding of the situation?

3 MS. KHAIRA: Yes, Judge Long.

4 JUDGE LONG: Thank you. And will 30 days be
5 enough time?

6 MS. KHAIRA: Yes.

7 JUDGE LONG: Okay. And, Mr. Tucker,
8 Mr. Canestrelli, you understand that you'll be given
9 an opportunity to respond to any objections?

10 MR. CANESTRELLI: Understood.

11 JUDGE LONG: Okay. Now, with respect to the
12 exhibits -- because both parties have used alphabetical
13 labeling -- please refer to FTB's exhibits by saying
14 FTB exhibit, and please refer to Appellant's by saying
15 Appellant's exhibit.

16 Moving forward. At the prehearing conference,
17 it was agreed that the following is not in dispute:

18 First, the note and warrant purchased
19 agreements two and three are not supported by copies of
20 promissory notes; with the caveat that they may have been
21 supported at one time, but there are currently no copies
22 available for Appellant to provide.

23 Two, solutions and software company did not
24 pay any interest on alleged loans;

25 And, three, because Appellant is

1 unable to provide written promissory notes for
2 agreements two and three, he's unable to establish a
3 maturity date.

4 Mr. Canestrelli and Mr. Tucker, is that your
5 understanding of what was discussed at the prehearing
6 conference?

7 MR. CANESTRELLI: That is of my understanding.

8 JUDGE LONG: Okay. And, Franchise Tax Board,
9 is that your understanding as well?

10 MR. KHAIRA: Yes.

11 JUDGE LONG: Thank you.

12 Today's hearing is expected to take
13 approximately two hours. We will begin with the
14 taxpayer's -- with the Appellant's opening presentation
15 and witness testimony. You have one hour, and you may
16 begin when ready.

17
18 PRESENTATION

19 MR. TUCKER: Good afternoon, your Honor. May
20 I please the Court.

21 JUDGE LONG: I'm sorry, real quickly. You
22 don't -- as I noted earlier, Office of Tax Appeals is
23 not a Tax Court; it's an independent agency, so you
24 don't have to use those formalities. And Judge Long,
25 Mr. Long is fine. I appreciate the respect, but it's

1 completely unnecessary to call me your Honor. And you
2 can just continue and go ahead without any further cues
3 from me. Okay?

4 JUDGE TUCKER: All right. Perfect. As
5 Judge Long previously stated, the only issue in this case
6 is the FTB's denial of Appellant, Alan R. Brayton's claim
7 for bad deducted -- bad debt deduction of \$3,525,000
8 dollars for the year 2014.

9 The Appellant sought this deduction under IRC
10 Section 166 and Conformed Section of the California
11 Revenue and Tax Code, Section 24348.

12 The key issues to determine are bona fide
13 debt -- is the key should determine bona fide debt is
14 Boatner v. Commissioner which provide factors that are
15 useful framework for distinguishing lumps from equity.
16 And each factor overwhelmingly supports Appellant's
17 position.

18 In particular, there are three factors of the
19 13 which provide clear and convincing evidence. The
20 first is the documents are labeled as promissory notes
21 and note and warranty purchase agreements. Terms
22 typically in loan agreements.

23 Second, the agreements specify fixed maturity
24 dates -- a key feature of loans.

25 Third, Appellant did not participate in the

1 management of S.I.S., further reenforcing the intent to
2 create ate debtor-credit relationship.

3 The FTB argues that the funds transferred from
4 Brayton Investments, which are going to be referred to
5 as B.I., to software in -- or solutions in software,
6 which are going to be referred to S.I.S., were equity
7 investments.

8 However, this mischaracterization
9 mischaracterizes the fact that the evidence, both
10 documentary and testimary (sic) -- testamentary will
11 show that these transfers were bona fide loans, and the
12 Appellant is entitled to the deduction.

13 The documentary evidence in a series of
14 note and warranty purchased agreements executed between
15 2003 and 2005. This is evidence in Appellant's Exhibits H,
16 I, and J, which are the first, second, and third note in
17 warranted purchase agreements clearly outlines the
18 repayment returns, fixed interest, promissory notes.
19 These are all hallmarks of bona fide debt as defined by
20 the Treasury of Regulation Statute 1.166-1.

21 Moreover, there are documents that show the
22 conduct of both parties after the agreement confirm --

23 JUDGE LONG: Mr. Tucker?

24 MR. TUCKER: Yeah.

25 JUDGE LONG: I'm sorry to interrupt, but I do

1 want to make sure that Ms. Rodriguez is able to catch
2 everything that you're saying. If you could just slow
3 it down a little bit. You're moving a little quick for
4 me, and I'm not responsible for the transcript. So I
5 want to make sure that we're getting everything that
6 you're arguing; all right?

7 MR. TUCKER: Of course. Thank you,
8 Judge Long.

9 JUDGE LONG: Thank you.

10 MR. TUCKER: Moreover, there are documents
11 that show the conduct of both parties after the
12 agreements confirms a debtor-creditor relationship.
13 Appellant never participated in the managing of S.I.S.,
14 and no shareholder rights were granted unless the
15 warrants were exercised; and option -- an option never
16 pursued by B.I. or Mr. Brayton.

17 Exhibit D, which contains E-mail exchanges
18 between S.I.S.'s President, Mr. Spies, and Appellant,
19 further supports this. In one exchange, Mr. Spies
20 acknowledges S.I.S.'s inability to repay and proposes
21 converting the debt into equity as a last resort.

22 If these transferred had been equated from the
23 start, there would have been no need for this proposal.
24 As we talk through this evidence, including Appellant
25 Exhibits H, I, and J, we will show that Brayton

1 Investments consistently acted as a creditor and not an
2 equity investor.

3 On the issue of worthlessness, by the end of
4 2014, S.I.S. was in severe financial distress and unable
5 to meet it's repayment obligations. Appellant's Exhibit
6 G, which contains E-mails from early 2015, includes a
7 clear admission from Mr. Spies that S.I.S. could not --
8 or could no longer repay the loan.

9 This is corroborated by the profit and loss
10 statement in Exhibit E which show that the companies --
11 which show the company's deteriorating financial
12 condition. Under IRC Section 166 and California Revenue
13 and Taxation Code Section 24348, a debt is considered
14 worthless when there is no reasonable expectation of
15 repayment.

16 Appellant made a prudent determination that
17 the debt was worthless in 2014 as documented by the
18 issuance of Form 1099-C. Testimony by Appellant and
19 Mr. Spies will confirm the documentary evidence,
20 finally, regarding the burden of proof.

21 Under IRC Section 7491, once Appellant
22 presents credible evidence through promissory notes,
23 financial records, and communication, the burden shifts
24 to the FTB. The FTB will not provide sufficient
25 evidence to rebut this. Their focus is on the

1 existence of warrants which were never exercised. This
2 does not change the nature of those transactions as
3 loan.

4 In conclusion, the evidence will clearly show
5 that these transfers were bona fide loans that became
6 worthless in 2014; entitling the Appellant to \$3,525,000
7 dollars of bad debt deduction.

8 We respectfully ask -- we respectfully ask the
9 panel to reverse the FTB's decision and deny and allow
10 the Appellant to claim the bad debt deduction.

11 MR. CANESTRELLI: That is our opening
12 statement. And, now, we're going to take direct
13 testimony to the Appellant.

14
15 A. BRAYTON,
16 produced as a witness, and having been first duly sworn
17 by The Administrative Law Judge, was examined and
18 testified as follows:

19 DIRECT EXAMINATION

20 BY MR. TUCKER:

21 Q. All right. Mr. Brayton?

22 A. Yes.

23 Q. Would you mind describing your professional
24 background and current occupation?

25 A. I'm a personal injury attorney and have been

1 for the last 40 years. Primarily representing victims
2 of toxic exposures including beryllium, silica,
3 asbestos, bad ground water, and a variety of other
4 things.

5 Q. Okay.

6 A. And I'm the founding partner in the firm.

7 Q. Okay. And successful firm; correct?

8 A. I would like -- I'd like to think we're
9 successful.

10 Q. Okay. In your practice, how often do you have
11 access to company's financial solvencies?

12 A. Well, I have access to my company's financial
13 solvency on a regular basis.

14 Q. Okay. When you -- are you familiar with
15 bringing suits against corporations?

16 A. Well, I sue corporations. In the course of
17 business, many of the defendants of litigation are
18 corporate defendants.

19 Q. Okay. How do you determine if a suit would
20 give you money -- right?

21 A. Well, I evaluate the strength of the
22 underlying case. Whether or not we can show negligence
23 or strict liability. And I look at the culpability of
24 the defendants that we sue, and we rarely get into
25 looking at whether or not their judgement of proof until

1 we actually get a judgement.

2 Q. If there's a company that you were bringing a
3 suit against, without insurance, would that factor in
4 afterwards? Would that factor in before or afterwards?

5 A. If I knew at the outset that there was no
6 insurance, I might try and ascertain if the company was
7 otherwise viable before proceeding against them.

8 Q. Okay. Did you have any connection with
9 Mr. Spies prior to investing in his company?

10 A. Yes. He was a vendor and was providing the
11 case management software utilized by my firm.

12 Q. Okay. When you signed an agreement with
13 Mr. Spies, how was it structured?

14 A. Well, the agreements that I guess you're
15 referring to are the promissory notes where I agreed to
16 lend him money through Brayton Investment Corporation,
17 and they were structured as promissory notes --
18 seven-year promissory note -- and do -- I believe in
19 2010. And as part of that promissory note, S.I.S issued
20 warrants that would allow them to -- to exercise the right
21 to stock in the company.

22 Q. Okay. Why did you invest and -- or why did
23 you provide a loan to S.I.S?

24 A. I provided a loan to S.I.S because I thought
25 they had a good product. I thought that it was viable

1 for my firm and would be viable for other firms,
2 particularly those involved in a mass tort litigation and
3 other complex litigation. And I thought the further
4 development of that product would benefit not only my
5 firm but would have economic viability.

6 Q. Okay. Did you ever convert your loan into
7 equity?

8 A. No.

9 Q. Why is that?

10 A. I never became convinced that -- that that
11 would be a prudent thing to do.

12 Q. Did you have access, or when you reached out
13 for repayment, did they provide you access to or
14 information regarding their financial status?

15 A. Well, yes. At the outset, they provided me
16 financial information and projections on where they
17 thought the company was going to go and how they were
18 going to expand it and provide a source of repayment.
19 And, then, along the way over the years, they would
20 periodically provide updated financial information.

21 Q. Okay. Did you ever attend any shareholder
22 meetings, or were you involved in the management of
23 S.I.S?

24 A. I never attended a shareholder meeting, and I
25 never had any involvement in the management of S.I.S.

1 Q. Did you record interest payments or other
2 financial charges related to the loans in accounting
3 records?

4 A. There were never any interest payments made,
5 so no interest payments were ever recorded. In 2010,
6 when they were due, they indicated they didn't have the
7 ability to repay and looking at their financial
8 statements, I concluded that that was correct -- that
9 they couldn't.

10 But they said, you know, we're still trying --
11 we're still trying to expand. And, so, we continued to
12 carry on until 2014.

13 Q. Okay. When did you have access to these
14 financial statements?

15 A. I believe that we got updated financial
16 statements every year. Kind of just a one-page summary
17 of profit and loss. That was all --

18 Q. You had --

19 A. That was all handled through my chief
20 financial officer.

21 Q. That was Matt Fleming; correct? Okay.

22 A. Matt Fleumer. Yes.

23 Q. Fleumer. Okay, perfect. Would you mind
24 explaining your CFO'S background for me?

25 A. Yeah. Matt was a graduate of West Point;

1 served in the army for 20 years and retired. During
2 that time, he became a certified public accountant.
3 Came out of the army, came to me with a few years of
4 experience in the real world, and we hired him as a CPA
5 and chief financial officer for the firm.

6 Q. Okay. Prior to writing -- prior -- prior to
7 deducting this debt as bad debt, did your CFO and you
8 talk about it, and did you consult an outside -- outside
9 CPA's to determine if it was reasonable?

10 A. Yes. We not only discussed it, we also
11 consulted Terry Cumbey an outside CPA.

12 Q. Okay.

13 THE COURT REPORTER: I'm sorry, can I have a
14 spelling on -- what was it --

15 MR. BRAYTON: Fleumer is, F-L-E-U-M-E-R.
16 Cumbey is, C-U-M-B-E-Y.

17 THE COURT REPORTER: You said, C-U-M-B-E-Y?

18 MR. BRAYTON: Yes.

19 THE COURT REPORTER: Thank you.

20 BY MR. TUCKER:

21 Q. Okay. Before declaring the debt worthless in
22 2014, what efforts were made? What did you do to ensure
23 that you would -- what did you do to try to receive
24 payment from S.I.S.

25 A. Well, we asked them repeatedly when they would

1 be able to resume payments, and they let their financial
2 statements speak for themselves.

3 Q. Why didn't you bring suit against S.I.S?

4 A. I was pretty familiar with the company at that
5 point, having watched the financials. Particularly from
6 2010 to 2014, they had no assets, and bringing suit, I
7 concluded, would be an exercise in futility.

8 I would get a judgement that I didn't think
9 would be collectible, and the best that would happen is
10 I become a creditor in bankruptcy with very little
11 likelihood of getting anything. So it was kind of like
12 no point to that point in throwing good money after bad.

13 Q. Were there any discussions about repayment
14 plans or restructuring the debt prior to 2014?

15 A. Several opportunities. See, Richard offered
16 to convert the debt equity, and I didn't think that that
17 would be in my best interest. And, in fact, as late as
18 early 2015, he still was offering to convert the debt
19 into equity, but it made no sense.

20 Q. In your communications with S.I.S, they
21 provided you with financial statements over the course
22 of years, and in 2014, what made this different than a
23 minimal gain in 2013?

24 A. I think that in 2014, it had been another four
25 years after the notes were due, and it appeared that it

1 was not going to get any better unless they turn their
2 business around.

3 I was unwilling to advance additional funds,
4 and they had no opportunity to go out and get additional
5 funds with this debt overhanging this company. So if
6 there was any project that he would be able to do
7 something, it would only be if he didn't have the burden
8 of this debt. And, so, I decided to write the debt off
9 at that time.

10 Q. Did you ever have any reason to believe that
11 the funds advanced to S.I.S were anything other than
12 loans based on your agreements and based on your
13 conversations?

14 A. No. All they provided were warrants and --
15 which were never executed.

16 Q. Did S.I.S ever attempt to argue that the funds
17 were equity contributions rather than loans?

18 A. No. In fact, up until the end, they made
19 offers to convert the loans to equity.

20 Q. And, our exhibits, the first promissory note
21 is not signed; did this reflect your agreement? Was
22 this ever signed?

23 A. I don't know if it was ever signed or not. If
24 it was signed, I don't know where it ended up.

25 Q. Okay. And it was --

1 A. But it accurately reflects our agreement.

2 Q. And it was 20 years ago, and the -- and it
3 looks like the wire transfers confirmed that you were
4 acting as if the agreement was valid?

5 A. Yes. I always treated it as valid.

6 Q. Okay. Did Brayton Investments ever issue a
7 9-C?

8 A. I'm not -- a 1099-C or 9-C?

9 Q. Yes. A 1099-C -- sorry.

10 A. Okay. Yes, in 2014, we issued a 1099-C.

11 Q. The second and third agreement do not have a
12 promissory note attached to them; was there a promise to
13 repay?

14 A. There was a promise to repay. I don't know if
15 they were ever executed as promissory notes or not. I
16 just don't recall, and Mr. Fleumer's no longer with me
17 so I could not locate notes for those agreements.

18 Q. Do you believe that the course of conduct
19 between you and Mr. Spies would indicate that there was
20 an enforceable promise to repay?

21 A. I never had any indication from him that he
22 didn't desire to repay it. He repeatedly said that he
23 was looking forward to the business taking off. In
24 fact, I think around 2009 or 2010, he laid out extensive
25 business plans to show how he was going to grow the

1 business and pay off the promissory notes.

2 MR. TUCKER: Okay, and no further questions.

3 MR. CANESTRELLI: Judge Long, do we do
4 cross-examination now, or should we call the next
5 witness for testimony?

6 JUDGE LONG: Actually, thank you for asking.
7 I was just about to offer Franchise Tax Board the
8 opportunity to do cross-examination now.

9 MR. CANESTRELLI: Okay.

10 JUDGE LONG: Franchise Tax Board, do you have
11 any questions for Mr. Brayton?

12 MS. KHAIRA: Yes, we do.

13

14 CROSS-EXAMINATION

15 BY MS. KHAIRA

16 Q. Good afternoon, Mr. Brayton. Thank you for
17 being here today. I visited your website, and I read
18 your biography; and I'd like to ask you some questions
19 about your background.

20 A. Sure.

21 Q. So you received a Bachelors of Science in
22 Economics from the United States Air Force Academy in
23 1971; is this correct?

24 A. That's correct.

25 Q. You received a Masters of Science in Finance

1 from UCLA in 1972; correct?

2 A. That's correct.

3 Q. You received your law degree from UC Berkeley
4 Boalt Hall School of Law in 1976; correct?

5 A. That's correct.

6 Q. You were admitted to the State Bar of
7 California in 1977; correct?

8 A. That's correct.

9 Q. And you're the founding and senior partner at
10 your law firm Brayton Purcell, LLP; correct?

11 A. Correct.

12 Q. You founded your firm in 1984; is this
13 correct?

14 A. That's correct.

15 Q. So you have approximately 40 years of
16 experience owning and managing your own law firm;
17 correct?

18 A. That's correct.

19 Q. Thank you. So I'm going to reference your
20 opening brief for the next few questions. In your
21 opening brief, on page 4, you state that, quote:

22 "The execution of a promissory note and
23 warrant purchase agreement is a regular
24 practice in corporate financing."

25 End quote. Correct?

1 A. Correct.

2 Q. The promissory note provided with the first
3 purchase agreement was not executed by S.I.S.; correct?

4 A. That it was not executed?

5 Q. Yes.

6 A. I -- I don't know. I believe -- I thought
7 that they executed the agreement. That's why I continued
8 to provide the funding.

9 Q. Okay.

10 A. But I -- I don't have a signed copy or
11 anything.

12 Q. Okay. Next question, in your opening brief on
13 page 5, you state that, quote:

14 "In the second and third purchase agreements
15 however, no promissory notes were executed."

16 End quote; is that correct?

17 A. I don't know if they were executed or not.
18 That was a long, long time ago.

19 Q. And, for reference, the quotes are statements
20 from your opening brief prepared by your attorney which
21 is in the record.

22 Next question, in explaining the absence of
23 executed promissory notes on page 5 of your opening
24 brief, you state that you were, quote:

25 "Assured that if S.I.S. does not issue

1 promissory notes or warrants, a constructive or result
2 in trust would exist with respect to the funds
3 transferred under Civil Code Section 224; one who gains
4 anything by fraud, accident, mistake, undue influence,
5 the violation of a trust, or other wrongful act is an
6 involuntary trustee of the thing gained for the benefit
7 of the person who would otherwise have had it."

8 End quote. Have you filed an action against
9 S.I.S. to impose a constructive trust on the funds that
10 you allege you transferred?

11 A. No, I have not.

12 Q. In your opening brief on page 3, you state
13 that, quote:

14 "When Brayton attempted to collect on its
15 loan from S.I.S. in the first quarter of 2015, S.I.S.
16 could not pay and instead offered to partially sell the
17 debt via equity as as evidence by the E-mail
18 correspondences by the two company's officers."

19 End quote. So according to this statement,
20 you were still attempting to collect on the debt in the
21 first quarter of 2015; is that correct?

22 A. No, I was not attempting to collect. That was
23 a proposal that Mr. Spies made back to us as we were
24 talking about doing the 1099. And documenting the fact
25 that we were going to take it as a bad debt.

1 Q. Okay. Next question, Brayton Investment
2 refused S.I.S.'s offer to take an equity position in
3 S.I.S.; is this correct?

4 A. Yes.

5 Q. S.I.S. did not make repayments of principal to
6 Brayton Investment; is that correct?

7 A. That is correct.

8 Q. In your response brief dated October 1st,
9 2021, on page 15, you state that, quote:

10 "Although the debt has declared worthless in
11 2014, in case it is recovered in the future, if S.I.S.
12 becomes financial, viable, Brayton Investments can make
13 such declaration of income in order to reverse the
14 effects of it's bad debt cancellation."

15 End quote. Your statement indicates a
16 possibility of collection of the debt in the future if
17 S.I.S. becomes financially viable".

18 Is that correct?

19 A. I think it merely reflects that if Richard
20 became wildly successful and decided to not withstanding
21 the fact that we had written off the debt to repay it, I
22 would have to take it into income at that time.

23 MS. KHAIRA: Thank you.

24 Those are all my questions.

25 JUDGE LONG: Thank you.

1 Mr. Tucker, Mr. Canestrelli, would you like to
2 proceed with your second witness?

3 MR. CANESTRELLI: Do we do follow up, or do we
4 do second witness, Judge Long?

5 JUDGE LONG: If you have questions for
6 Mr. Brayton, go ahead and do those questions.

7 MR. CANESTRELLI: I have one question.
8

9 REDIRECT EXAMINATION

10 BY MR. CANESTRELLI:

11 Q. As far as the FTB attorney's question
12 regarding that you would take income, if you were
13 somehow repaid the debt in the future, what was your
14 understanding of that as far as why you were required to
15 take it up as income?

16 A. I guess my understanding was that if I was
17 wrong and that it was not a bad debt and somehow it was
18 paid to me in the future, that it would be appropriate
19 to treat it as income.

20 Q. Are you familiar with the tax benefit rule
21 doctrine in tax law?

22 A. No. I am not a tax law expert.

23 MR. CANESTRELLI: Okay. All right. No
24 further questions.

25 JUDGE LONG: Thank you. You may begin with

1 your next witness when ready.

2

3 R. SPIES,

4 produced as a witness, and having been first duly sworn

5 by The Administrative Law Judge, was examined and

6 testified as follows:

7 DIRECT EXAMINATION

8 MR. CANESTRELLI:

9 Q. Okay. Mr. Spies, thank you again for
10 attending the conference and giving testimony. Can you
11 please introduce yourself and explain a little bit about
12 your role at S.I.S. during these years, 2003 to roughly
13 2014.

14 You're muted, Mr. Spies. We still cannot hear
15 you.

16 JUDGE LONG: Mr. Spies, we seem to be having
17 some microphone trouble again. So we're going to take a
18 quick five-minute break, and someone from OTA will reach
19 out and help you. Okay. And, in the mean time,
20 everyone else will be returned to the waiting room, and
21 the ALJs in the panel will also.

22 (Off the record.)

23 JUDGE LONG: Let's go back on the record.

24 And Mr. Canestrelli --

25 MR. TUCKER: Mr. Canestrelli just stepped out

1 to take a bio break. He thought it was going to be
2 another five minutes. Sorry about that.

3 JUDGE LONG: No problem. Then we will take a
4 five-minute break, and we'll adjourn at 3:42.

5 (Short Break.)

6 JUDGE LONG: We're going back on the record.

7 Mr. Canestrelli, you may begin when you're
8 ready.

9 BY MR. CANESTRELLI:

10 Q. Hello, Mr. Spies, how are you doing today?

11 A. I'm doing pretty well.

12 Q. Okay. Can you please introduce yourself and
13 explain your role at S.I.S. during 2003-2015?

14 A. I've been president of the company since --
15 actually, when I joined the company --

16 Q. And when is the company --

17 A. 2000 and -- beg your pardon?

18 Q. No, go ahead. I apologize.

19 A. I -- I joined the company as a partner
20 initially in 2000 and developed and oversaw the
21 development of the product. And Mr. Brayton was one of
22 the -- my clients in the process and been managing that
23 since. I'm not a typical -- not a technology person, so
24 I do finance background.

25 Q. And can you explain a little bit more about

1 your finance background?

2 A. It was -- so it was commercial real estate,
3 did offerings back in the 80's and 90's. Worked for
4 Robert for my next venture for awhile which had a lot to
5 do with securitizing so that's -- started my own
6 development company. So I did real estate, which of
7 course involves finance. And, then, in 2000, I joined
8 S.I.S., and within a short period of time, bought out
9 the president of the company because we had different
10 ideas of what we should do and been operating the
11 company since then.

12 Q. Thank you. You had mentioned that Mr. Brayton
13 was a client of your -- of S.I.S. When did you -- when
14 did -- when did you start discussing his loan to S.I.S.?

15 A. Well, Mr. Brayton had already engaged with the
16 company -- by the time I owned the company. So they
17 were already in the process of negotiating a software
18 agreement or demonstrating a software back in 2000,
19 2001. We deployed; at that point, I met with
20 Mr. Brayton during that time.

21 And I suppose it was some time in 2002 that
22 I -- I thought it would be a -- I didn't get financing
23 for the company so that we could expand our platform --

24 JUDGE LONG: Mr. Spies. Mr. Spies, I'm sorry
25 to interrupt you. There's some auto quality issues, and

1 it seems to increase when you scoot away from your
2 microphone. So maybe try just staying closer to
3 your microphone. And --

4 MR. SPIES: I will do that.

5 JUDGE LONG: -- hopefully that helps. Thank
6 you.

7 MR. SPIES: Okay. So. Did you catch most of
8 that?

9 MR. CANESTRELLI: No, I did not.

10 THE COURT REPORTER: I didn't get that last
11 part. It's kind of choppy when he does speak. So it's
12 kind of hard to get everything down.

13 MR. SPIES: Okay. Seems to be having plenty
14 of audio issues today.

15 MR. CANESTRELLI: Yeah.

16 MR. SPIES: I'll try to speak more slowly and
17 be clear.

18 MR. CANESTRELLI: Okay.

19 MR. SPIES: So I met Mr. Brayton after the
20 company -- had engaged with him after he purchased the
21 software. Told him that I would like to grow the
22 company more quickly and ask about the possibilities of
23 borrowing funds from him because he obviously had a very
24 successful operation. And he was a client, so I thought
25 the prospect would be -- would be good, and he agreed.

1 BY MR. CANESTRELLI:

2 Q. And what was your understanding of the
3 investment as a loan or as equity?

4 A. It was -- it was a convertible note as far as
5 I was concerned. I've always referred to it as a note --

6 THE COURT REPORTER: I'm sorry, repeat that
7 last part. You said, "I've always referred to it as a
8 note," and then you cut off.

9 MR. SPIES: I refer to it as a note, and you
10 see that in my correspondence. I've always viewed as a
11 debt obligation.

12 Q. Did you ever treat Brayton Investments as a
13 shareholder of S.I.S. -- send them a notice of
14 shareholder meetings, ask them to vote for directors,
15 anything of that nature?

16 A. Not at all.

17 Q. Okay. I have provided Appellant's Exhibits H,
18 I, and J, which are the series of note and warrant
19 purchase agreements. Did you get a chance to review
20 those?

21 A. I looked at them quickly.

22 Q. Do they seem like the documents that were
23 prepared to memorialize the loan at the time?

24 A. Yes. I -- when we originally entered into the
25 first document, I had -- pretty comfortable with the way

1 the note and --

2 JUDGE LONG: I'm sorry, Mr. Spies. I'm sorry,
3 can you repeat the last few sentences. I wasn't able to
4 hear what you're saying. And, actually, since you're
5 having significant microphone issues --

6 MR. SPIES: Would you --

7 JUDGE LONG: -- it may be best for you to turn
8 off your video to increase the bandwidth or to use the
9 phone audio option of this meeting. So I would suggest
10 that we start with maybe turning off your video so that
11 might increase your bandwidth.

12 MR. SPIES: Okay.

13 JUDGE LONG: Okay. Lets give that a try, and
14 I hope we can go -- I hope it works better. And if you
15 could just repeat the last few things that you said so
16 that we can all understand.

17 BY MR. CANESTRELLI:

18 Q. I was asking you a question about the
19 Exhibits H, I, and J, the note and warrant purchase
20 agreements signed by S.I.S. and Brayton investments; did
21 those seem like the documents that were signed back in
22 2004?

23 A. They reflect my understanding of our agreement.
24 Yes.

25 Q. Do you know if there are any signed copies

1 of both sides of those notes?

2 A. No. When the question initially came up, I
3 did look extensively for the documents, and I've been
4 unable to locate them.

5 Q. Was your understanding that those agreements
6 were enforceable?

7 A. Yes.

8 Q. So if you look at Exhibits -- Appellant's
9 Exhibit C which has the breakdown of the financial
10 transactions between Brayton Investments and S.I.S.;
11 does that look correct as you recall?

12 A. I went back and looked at a balance sheet for
13 2013, and the amounts coincided.

14 Q. Okay.

15 A. So we reflected that as a debt.

16 Q. And if you look at Appellant's Exhibit B which
17 are wire transfers to Brayton Investments to S.I.S.; do
18 those reflect what you recall the monies coming into
19 S.I.S.?

20 A. Yeah. Obviously, it's difficult to remember
21 all of the transactions that occurred. But, yes, that
22 seems to reflect -- it seems likely to reflect what
23 occurred. I did provide bank statements as well, so I
24 assume those would match up.

25 Q. So take me through what happened as far as

1 repayment is concerned. Did S.I.S. ever repay in either
2 interest or principal on these notes?

3 A. No, we were unable to. We -- we cut back on
4 staff, we went by -- we had 19 or 20 employees when
5 receipts from Mr. Brayton. We got no further loan
6 receipts, and we had to cut back our staff
7 substantially.

8 I'm sorry, did I lose track of the question
9 there?

10 Q. No. So when did you inform Mr. Brayton that
11 you would not be able to repay the loan?

12 A. I believe it was -- yeah, that's a definitive
13 statement. I'm not able to repay the loan.

14 Q. Oh.

15 A. My -- probably have been, for instance, when
16 I'm making proposals to him which would have been
17 something to the effect of in an effort to get him some
18 kind of recovery, to tell him that we could get no
19 additional funding carrying a dead burden of millions of
20 dollars. I had no additional as far as the funds, so I
21 I didn't say I couldn't pay your loan, but I certainly
22 gave him the impression that I wouldn't be able to repay
23 the loan unless we did something to restructure the
24 debt.

25 In part of at least one or two proposals in

1 restructuring the debt was to convert the equity -- an
2 equity position and write substantial part of the debt.

3 Q. And did you -- did Mr. Brayton accept an
4 equity position verses a debt position?

5 A. No, he did not.

6 Q. So going to 2014 forward to 2014, what was the
7 financial situation of S.I.S. at that point.

8 A. Desperate. I've had -- I was investing some
9 of my own funds at that point, taking salary over that
10 five-year period leading up to that point. My salary
11 probably averaged \$140,000 dollars a year. There were --
12 distributions if all to the shareholders.

13 Q. And did --

14 A. And, obviously, there was no possibility of
15 repaying the debt.

16 Q. So at that point in 2014, did Mr. Brayton
17 start discussing just discharging the debt at that
18 point?

19 A. Yes. I believe it was primarily through Matt
20 Fleumer that that conversation occurred.

21 Q. And were you aware of what the tax
22 implications to S.I.S. would be if they discharge the
23 debt?

24 A. I contacted an accountant to make certain that
25 my understanding was correct. But, yes, my expectations

1 if they forgave the debt, it would be income for me, for
2 my company. And in becoming an income to S.I.S., the
3 question was if we have losses offset in.

4 And because we had initially spent all the
5 money on expenses of operation, it was pretty clear that
6 we would come pretty close to being able to cover the
7 1099 income with the losses.

8 Q. Was that information shared with Mr. Brayton?

9 A. Yes.

10 Q. And was a 1099-C issued from Brayton
11 Investments to S.I.S. for 2014?

12 A. Yes.

13 Q. Was there any formal paperwork between the two
14 companies that indicated that this debt was now
15 discharged, and they were no longer going to pursue it?

16 A. Yes, I was notified by E-mail that the debt
17 had been discharged and that a 1099 would be issued.

18 MR. CANESTRELLI: Okay. All right. I have no
19 further questions for this witness.

20 JUDGE LONG: Thank you.

21 Franchise Tax Board, do you have any questions
22 for Mr. Spies?

23 MS. KHAIRA: Yes.

24 ///

25 CROSS-EXAMINATION

1 BY MS. KHAIRA:

2 Q. Good afternoon, Mr. Spies. Thank you for
3 being here today. I have one question for you. Is
4 S.I.S. operational today?

5 A. Yes, it is.

6 Q. Okay. Thank you.

7 Those are all my questions.

8 JUDGE LONG: Thank you. Before we move
9 forward with Franchise Tax Board's presentation -- or,
10 actually, sorry. Before we move forward,
11 Mr. Canestrelli and Mr. Tucker, does that conclude your
12 opening presentation?

13 MR. CANESTRELLI: Yes, it does, your Honor.

14 JUDGE LONG: Okay. Before we move forward
15 with Franchise Tax Board's presentation, I'd like to
16 turn to my co-panelist.

17 Judge Ralston, do you have any questions?

18 JUDGE RALSTON: No questions at this time.
19 Thank you.

20 JUDGE LONG: Judge Long, do you have any
21 questions?

22 JUDGE VERONICA LONG: I'm going to hold my
23 questions till the end. Thank you.

24 JUDGE LONG: Thank you. I just have a few
25 questions. With respect to the 2014 return for Brayton

1 Investments, it does show a deduction for other
2 investments as opposed to a deduction for bad debt. Is
3 there an explanation the CPA's characterization of this
4 production -- of the deduction on this way on the
5 return?

6 MR. BRAYTON: I don't know what that
7 explanation might be. I -- I just rely on the CPAs.

8 JUDGE LONG: Fair enough. Was it the same CPA
9 that recommended that you write off this as a bad
10 deduction?

11 MR. BRAYTON: Yes, it was not Mr. Fleumer. I
12 think the returns were prepared by CCK.

13 JUDGE LONG: Okay. With respect to
14 Appellant's opening brief, I think we already covered
15 that no promissory notes were issued with respect to the
16 second or third agreement. And Mr. Brayton or your
17 representative from Brayton Investments protested the
18 non-issuance; were those protest in writing? Is there
19 any documentation available -- that type of protest?

20 MR. BRAYTON: I don't recall.

21 JUDGE LONG: Okay.

22 MR. BRAYTON: We didn't find anything when we
23 looked.

24 JUDGE LONG: Okay. Thank you.

25 And, then, Mr. Spies, just very quickly. My

1 understanding from the file is that in 2014, you
2 informed B.I. that you'd be closing your business; is
3 that correct?

4 Mr. Spies, are you there?

5 MR. SPIES: Yes. I believe it was something
6 to the effect of I cannot continue to operate with the
7 debt loan we were currently carrying, so we would have
8 to close the business.

9 JUDGE LONG: Okay. Thank you. And I believe
10 that concludes all of my questions for the moment.

11 Franchise Tax Board, you requested you
12 requested -- hold on, one minute,.

13 (Reporter asks to start a new file.)

14 JUDGE LONG: Yes. Sure.

15 So we're off the record for a moment, but
16 don't go anywhere.

17 (Off the record.)

18 JUDGE LONG: Let's go back on the record.

19 Franchise Tax Board, you requested 30 minutes
20 to make your presentation, and you may begin when ready.

21

22 PRESENTATION

23 MS. KHAIRA: Thank you. I think we'll take
24 less than that. Okay.

25 The issue before us today is whether Appellant

1 has established that he is entitled to claim a
2 pass-through loss of approximately \$3.526 million from
3 his wholly owned S-corporation due to the
4 S-corporation's claimed bad debt deduction in the year
5 2014.

6 I will outline the pertinent facts in this
7 case. Appellant is a California attorney and a
8 supervising partner in Brayton Purcell, LP, a California
9 law firm. Appellant is the sole shareholder of Brayton
10 Investment company, an S-corporation which I will refer
11 to as Brayton Investment.

12 Brayton Investment purportedly made wire
13 transfers totaling approximately \$3.525 million to
14 Solutions and Software, a Texas Corporation, which I
15 will refer to as S.I.S.. These transfers were made
16 March 2003 and December 2005.

17 Brayton Investments reported these alleged
18 transfers as other investments on the income tax return.
19 Appellant provided copies of three note and warrant
20 purchase agreements, which I will refer to as Agreement
21 1, Agreement 2, and Agreement 3, and provided
22 corresponding documents that he contends substantiate
23 the transfers of funds between Brayton Investment and
24 S.I.S..

25 Additionally, Appellant provided a series of

1 E-mails between Brayton Investment representatives and
2 S.I.S. representatives which Appellant contends
3 substantiate S.I.S.'s insolvency and inability to repay
4 the transferred fund.

5 In a letter provided at audit, Appellant
6 stated that in December 2014, he was notified by the
7 president of S.I.S. that S.I.S. will be closing and all
8 staff was to be released. This would effect investment
9 in the company.

10 Appellant further stated that based on advice
11 from a CPA intact attorney, it was determined that
12 Appellant's investment in S.I.S. should be written off
13 as there was no hope of redeeming the S.I.S. notes for
14 loan.

15 Now, I will explain how these transfers were
16 reported on the tax return.

17 Brayton Investments reported these alleged
18 transfers as other investments on it's income tax
19 return. On it's 2004 return, Brayton Investments
20 reported investments in S.I.S. totaling \$1,550 dollars.
21 On it's 2005 return, Brayton Investments reported
22 investments in S.I.S., totaling in \$3.525 million.

23 Then on it's 2014 tax return, Brayton
24 Investments reported an ordinary loss of \$3.526 million
25 approximately relating to investments in S.I.S. and zero

1 bad debts for the tax year. Brayton Investment issued
2 Appellant a 2014 California Schedule K-1 and reported
3 Appellant's pro rata share of it's ordinary business
4 losses as approximately \$3.526 million.

5 Appellant then reported his pass-through
6 business loss on his 2014 personal tax return.
7 Appellant contends that the purported transfers
8 purported as investments in S.I.S. were actually loans
9 which became worthless in 2014; and, therefore, Brayton
10 Investment was entitled to a bad debt deduction.

11 Now, I will go over Respondent's position.
12 Respondent's position is that:

13 One, Appellant has failed to establish the
14 existence of a bona fide debt; and, two, failed to
15 establish that the purported transfers purported as an
16 investment became worthless in 2014.

17 I will speak to the relevant legal
18 authorities. Internal Revenue Code 166, subsection (a),
19 allows for the deduction of a business debt that becomes
20 worthless within the taxable year. Under Treasury
21 Regulation, Section 1.166-1, sub (c), only a bona fide
22 debt qualifies for purposes of a bad debt deduction.

23 A bona fide debt is defined as a debt which
24 arises from a debt or creditor relationship based on a
25 valid and an enforceable obligation to pay a fixed or

1 determinable sum of money.

2 If the existence of a genuine debt cannot be
3 established, the advance of funds, if any, may be
4 considered a gift or a capital contribution. Either of
5 which is not a debt. Whether a bona fide debt or
6 creditor relationship exist is a question of fact to be
7 resolved in light of all pertinent facts.

8 An essential element is whether there is a
9 good-faith intent of the receipt of the fund to repay
10 and a good faith intent on the part of the person
11 advancing the funds to enforce repayment. The taxpayer
12 bears the burden of proving a bona fide debt exist.

13 Appellant contends that Agreement's 1, 2, and
14 3 evidence a debt or creditor relationship between
15 Brayton Investment and S.I.S. Appellant relies on the
16 factors in Boatner v. Commissioner to establish the
17 existence of a bona fide debt -- this is an incorrect
18 case. Boatner v. Commissioner allies loans verses
19 investments to a closely held corporation.

20 In Boatner, the purported loan is between
21 petitioner and its closely held corporation. Facts are
22 inapplicable to the fact of this case.

23 The correct case is Welch v. Commissioner. In
24 Welch, the Court defined a loan as an agreement,
25 expressed or implied, where one person advances money to

1 the other and the other agrees to repay on terms, such as
2 time or interest rate as the parties may agree. The
3 Courts stated that in making this determination, Courts
4 consider several factors as indication as a bona fide
5 loan.

6 I will go over each of the seven factors. I
7 will analyze how Appellant has not met each of the
8 factors, how Appellant is not credible, and how
9 Appellant's contentions were based on a series of
10 contradictions.

11 The first factor: Whether the promise to
12 repay is evidence by a note or other instrument, the
13 only note that Appellant provides to substantiate the
14 existence of a bona fide debt is a note in Exhibit B
15 from Agreement 1 which is not fund by S.I.S.

16 So the note alone is not evidence of its
17 validity, and Appellant has not established that the note
18 was valid or enforceable by Brayton Investments.

19 Also, Appellant concedes that Agreements 2
20 and 3 are not supported by promissory notes or a
21 security interest. Appellant has not provided a single,
22 fully executed promissory note or other instrument that
23 supports a promise to pay a bona fide debt.

24 Additionally, Brayton Investments own
25 bookkeeping records and tax returns all prepared by the

1 same CPA and signed under penalty of perjury by
2 Appellant all account for the alleged transfers as
3 investments and not loan; and account for zero in bad
4 debt.

5 However, in an E-mail between Brayton
6 Investments and S.I.S., dated January 28th, 2015, the
7 same CPA discusses uncollectible loans and the issuance
8 of the form 1099. Appellant provided no explanation for
9 these contradictory statements. Appellant has failed to
10 establish that the promise to pay is evidence by a note
11 or other instrument.

12 The second factor: Whether interest was
13 charged. Appellant admits that S.I.S. failed to pay
14 interest. Additionally, Appellant has not provided no
15 evidence to substantiate that Brayton Investments ever
16 actually charged any interest or even attempted to
17 enforce interest payments, much less if any interest is
18 paid.

19 Number three: Whether if fixed schedule for
20 repayments was established. Firstly, Appellant
21 concedes that repayments were not made. Second, there
22 was no repayment established by agreement, by note, or
23 by any other instrument.

24 The promissory note attached to Agreement 1
25 specifies a principal amount with a five percent

1 interest rate with a fixed maturity date of November,
2 blank, 2010; however, the date is incomplete, and the
3 note does not include a fixed schedule for repayment.

4 As previously noted, Appellant concedes that
5 neither Agreement 2 nor Agreement 3 are supported by
6 promissory notes or security interest. And Appellant
7 provided no evidence that either of these agreements
8 provided an interest rate, a fixed maturity date, or a
9 fixed schedule for repayment.

10 Number four: Whether collateral was given to
11 secure a payment. Appellant has not contended that
12 Brayton Investment received any collateral to secure
13 payment, and there's no provision for collateral and the
14 only promissory note is Agreement 1.

15 In a January 8th, 2015 E-mail, S.I.S. offered
16 Brayton Investment an equity position in S.I.S. in lieu
17 of debt. However, in a subsequent E-mail, dated
18 January 23, 2015, Brayton Investment rejected S.I.S.'s
19 offer of collateral and opted to write off the alleged
20 debt.

21 Number five: Whether repayments were made.
22 Appellant conceded that no repayments of principal or
23 interest were ever made.

24 Number six: Whether the borrower had a
25 reasonable prospect of repaying the loans and whether

1 the lender had sufficient funds to advance the loan.

2 Appellant conceded that S.I.S. periodically
3 provided financial statements to Brayton Investment that
4 showed S.I.S.'s inability to make any interest payments
5 on the \$1.14 million note in Agreement 1 due to issues of
6 cash flow.

7 Appellant -- additionally, Appellant conceded
8 that Brayton Investment did not enforce payments of
9 interest or principal of the note in Agreement 1 as it's
10 maturity date because in reviewing S.I.S.'s financial
11 statements, it became clear that S.I.S. had no ability
12 to satisfy their loan obligations.

13 Number seven: Whether the parties conducted
14 themselves as if the transaction were a loan. Brayton
15 Investment did not appear to maintain corporate
16 formalities with respect to the purported loans, and the
17 alleged arrangement was largely undocumented.

18 Appellant produced a single incomplete and
19 unexecuted promissory note for \$1.45 million which does
20 not contain a repayment schedule or collateral to secure
21 a payment. The absence of these provisions is just that
22 it is not a bona fide debt.

23 Appellant has an undergraduate degree in
24 Economics, a masters in Finance, and received his bar at
25 California Bar Admission in 1977. Appellant is a

1 sophisticated business person. His 2014 Tax Return
2 shows Appellant has a large and sophisticated portfolio
3 of investments and businesses.

4 Appellant has been a licensed and trained
5 attorney for 40 years; a supervising partner of law
6 firm; and, thus, Appellant's conduct and Brayton
7 Investment's conduct does not add up. Brayton
8 Investment reports the purported transfers as
9 investments; however, Appellant contends they are loans
10 but cannot provide substantiation.

11 Appellant opted to lend 3.525 of funds, three
12 point -- excuse me. Appellant opted to lend \$3.525
13 million dollars of fund without collateral or promissory
14 notes and with incomplete agreements. It doesn't make
15 sense that Appellant would transact a business
16 arrangement without corporate formalities.

17 According to Appellant's own arguments, after
18 S.I.S. failed to make any interest payments on the first
19 purported loan, Brayton Investment continued to lend
20 money. And then after S.I.S. offered an equity position
21 in S.I.S. in lieu of debt, Brayton Investment declined
22 any form of repayment and opted to forgive all 3.525
23 million interest.

24 Brayton Investment never filed suit against
25 S.I.S. or attempted to secure repayment under Civil Code

1 Section 2224. Appellant's contentions are contradictory
2 and inconsistent with basic business and legal practice.

3 Appellant has failed to establish that the
4 alleged debt became worthless during the 2014 tax year.
5 Assuming that the amounts transferred constituted a
6 debt, the determination of whether Appellant is entitled
7 to a bad debt loss deduction turns on whether the
8 alleged debt S.I.S. owed to Brayton Investment became
9 worthless in 2014.

10 Most courts consider both the liquidating
11 value and the potential value of the company to
12 determine the year of worthless.

13 In *Bilthouse v. United States*, the Court
14 reasoned that even where a company has no liquidating
15 value, evidence of a potential value can be used to
16 demonstrate that company is not yet worthless during a
17 particular year.

18 In that regard, S.I.S. was still in business
19 during the year at issue, based on Appellant's own
20 assertion, and remains in business to this day. This
21 refutes the assertion that the alleged debt became
22 worthless in 2014.

23 Additionally, in his reply brief, Appellant
24 indicated that he still had hope to recover the alleged
25 debt because it still has potential value due to the

1 possibility that it will be collectible in the future.
2 By Appellant's own omission, the alleged debt is not
3 lacking in potential value.

4 In any case, Appellant has not substantiated
5 that S.I.S. was in financial trouble. Appellant has not
6 provided credible evidence to show the existence of a
7 debt and its worthlessness in the 2014 tax years.

8 This concludes Respondent's argument. Thank
9 you.

10 JUDGE LONG: Thank you.

11 I would like to turn over to my co-panelists
12 to see if they have any questions.

13 Judge Ralston, do you have any questions?

14 JUDGE RALSTON: No questions. Thank you.

15 THE COURT: And, Judge Long, do you have any
16 questions?

17 JUDGE LONG: I do have a question for
18 FTB's Counsel.

19 During Appellant's Counsel presentation, they
20 discussed a burden shifting that supposedly would take
21 place in the event that appellants are able to meet
22 their burden of proof. And when I confirmed in the
23 briefing, their setting to Internal Revenue Code Section
24 7491; I just want to ask FTB -- does Internal Code
25 Revenue Code Section 7491, does that apply in this case?

1 Does California conform?

2 MR. MILLER: It does not apply in this case,
3 your Honor. The burden of proof standard 7491 refers to
4 a court proceeding where a taxpayer introduces credible
5 evidence with respect to any factual issue relevant to
6 ascertain a liability of the taxpayer. Even if it did
7 apply, Appellants haven't produced any credible evidence
8 with respect to any factual issue as outlined in our
9 presentation. The burden rules are very specifically
10 identified in the OTA'S own regulations.

11 JUDGE VERONICA LONG: All right. Thank you,
12 FTB. I just wanted to go ahead and confirm because I
13 didn't see it discussed in the briefing specifically.
14 Thank you.

15 That's all of my questions for FTB at this
16 time.

17 JUDGE LONG: Thank you, and I think that
18 clarifies my questions as well. So with that in mind,
19 we're going to move on to Appellant's final statement.

20 Mr. Canestrelli, Mr. Tucker, you requested an
21 additional 10 minutes to make your closing argument.

22 MR. CANESTRELLI: Right.

23 And you may begin when ready.

24 FINAL STATEMENT

25 MR. CANESTRELLI: Okay. FTB'S position that

1 this was a secret equity purchase contrary to all the
2 documentation and the testimony is nonsensical. If it
3 was an equity purchase, Brayton Investment could have
4 deducted their investment as a S-corporation shareholder
5 annually, wouldn't have to wait until 2014 when the debt
6 was completely unpayable to try to recoup their
7 investment with a cancellation of debt for tax purposes.

8 So I do think that Appellant has shown
9 documentation and testimony and evidence that shows that
10 the Appellant is entitled to the deduction. I do think
11 that Boatner v. Commission is a correct case for this
12 situation because it directly addresses the court issues
13 that we are facing; the distinction was bona fide debt
14 and equity.

15 Welch v. Commissioner is more focused on
16 ordinary verses necessary business expenses which is not
17 an issue in this case. I do think that the note -- the
18 note and warrant purchase agreements and the testimony
19 and the history of this debt for 10 years shows that we
20 have, under the Boatner test, have proved that there was
21 legitimate debt. A name given to the instrument --
22 promissory note, note, and purchased agreements; that's
23 one of the Boatner factors, and I think that's in favor
24 of it.

25 Fixed maturity debt -- not on all the notes,

1 not on all the agreements, but there was on at least
2 one. Again, something that shows a debt or creditor.
3 Source of repayment, S.I.S. was supposed to make a lot
4 of money on their software; it didn't happen, but that
5 is what the petitioner was relying on the payment.

6 Right to enforce payment -- again, those
7 documentations and everybody's understanding was that
8 Brayton Investment could enforce their right. There was
9 no participation of management by Brayton Investment at
10 any stage.

11 Adequate capitalization, S.I.S. faced
12 financial difficulties. Brayton loans were there to
13 help them capitalize it, and they were hoping that this
14 software would take off and everybody would be paid; and
15 Brayton would be paid back.

16 Intent of the parties, I don't see anything
17 that points to any type of an equity intent. That would
18 have been -- like I said, more favorable to Appellant if
19 they would have treated this as equity from the get go.

20 And then the other factors taken all-and-all
21 as put in our briefs, I think we have met the standard
22 of the -- of the 13-point factor test of Boatner. As
23 far as the worthlessness of the debt is concerned, the
24 evidence strongly concludes that it became worthless in
25 2014.

1 S.I.S. could not do what they were doing.
2 They couldn't function. Yes, S.I.S. still exists, but
3 it probably exist because of the discharge of the debt.

4 As far as the Appellant's statements regarding
5 that maybe he'll get paid back again; he's just
6 following the tax benefit rule, which indicates that if
7 something changes down the road and you received a tax
8 benefit, such as a cancellation of debt and then somehow
9 some miracle, now 10 years beyond that. You somehow get
10 paid this debt. You are supposed pick that up as income
11 in the year received.

12 I don't think that is ever going to happen.
13 Its been discharged, and I don't think the client is
14 ever going to get paid. But if he does, the tax benefit
15 rule would compel him to pick that up as income in the
16 year received because he took the tax benefit rule.

17 In conclusion, I think the facts, the
18 documentary facts -- yes, they are not complete. But
19 this is a transaction from 20 years ago, but it
20 certainly is strongly (sic) evidence that this was a
21 debtor/creditor relationship, not an equity
22 relationship, and that the debt became uncollectible in
23 2014.

24 And we respectfully request that this Court
25 reverses the Franchise Tax Board denial of this

1 deduction. Thank you.

2 JUDGE LONG: Thank you. And before we
3 conclude this hearing, I just want to double-check with
4 my co-panelists.

5 Judge Ralston, do you have any questions
6 before we go?

7 JUDGE RALSTON: No, thank you.

8 JUDGE LONG: Judge Long, do you have any
9 questions before we go?

10 JUDGE VERONICA LONG: I do have one question
11 for Appellant's Counsel.

12 Mr. Canestrelli, you said that if this had
13 been reported as equity instead of debt that there would
14 have been losses being taken among the years before
15 without waiting for 2014 to have a bad debt deduction.
16 I just want to confirm my understanding is -- that was
17 in your closing statement; is that right?

18 MR. CANESTRELLI: That is correct.

19 JUDGE VERONICA LONG: All right. So are you
20 making, like, an alternative argument? That if this
21 were to be considered equity instead of debt, that
22 Appellant should be allowed some amount of loss.

23 MR. CANESTRELLI: No, I am not. I'm just
24 pointing out the Franchise Tax Board's position does not
25 reflect on the reality of the situation. Why wait 10

1 years and not getting paid if this was equity all along.
2 And that's my understanding of Franchise Tax Board's
3 position. This is somehow crypto equity that he
4 invested in.

5 Don't look at the warrants, don't look at, you
6 know, the testimony, the understanding, the E-mails back
7 and forth -- this was equity all along, which makes no
8 sense because if it was equity, would he take advantage
9 of it? For 10 years?

10 JUDGE VERONICA LONG: Okay. Thank you,
11 Mr. Canestrelli. That answers my question.

12 MR. CANESTRELLI: Thank you, Judge.

13 JUDGE LONG: Thank you. With that, we are
14 ready to conclude this hearing. As discussed at the
15 beginning of the hearing, the record will be held open
16 for 30-days, which, in this case, is October 17th for
17 Franchise Tax Board to review the documentation which
18 was received today and provide any objections.

19 At that time, if there are any objections,
20 Appellant's Counsel will be given the opportunity to
21 respond. Thank you for -- thank you to everyone for
22 appearing today. The Administrative Law Judges will
23 meet and discuss your case later on, and we'll send you
24 a written opinion of our decision within 100 days of
25 closing the record.

1 Today's hearing in the Appeal of Brayton is
2 now adjourned, and this concludes our calendar for the
3 day. Thank you.

4 (Proceeding adjourned at 4:29 p.m.)
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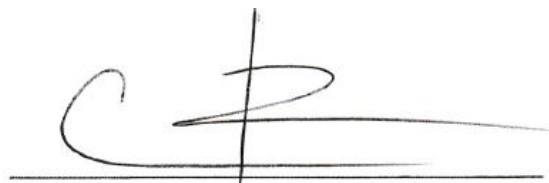
1 HEARING REPORTER'S CERTIFICATE

2
3 I, Christina L. Rodriguez, Hearing Reporter in
4 and for the State of California, do hereby certify:

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

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

14 I have hereunto subscribed my name this 10th
15 day of October, 2024.

16
17
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19 

20 Hearing Reporter

21 CHRISTINA RODRIGUEZ
22
23
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25

<hr/>	1976 26:4	23 50:18	absence 27:22 51:21
\$	1977 26:7 51:25	24348 12:11 15:13	Academy 25:22
<hr/>	1984 26:12	28th 49:6	accept 39:3
\$1,550 45:20	1st 29:8	2:30 5:2,9	access 17:11,12 19:12,13 20:13
\$1.14 51:5	<hr/>	<hr/>	accident 28:4
\$1.45 51:19	2	3	account 49:2,3
\$140,000 39:11	<hr/>	<hr/>	accountant 21:2 39:24
\$3,525,000 12:7 16:6	2 44:21 47:13 48:19 50:5	3 28:12 44:21 47:14 48:20 50:5	accounting 20:2
\$3.525 44:13 45:22 52:12	20 21:1 24:2 38:4	3.525 52:11,22	accurately 24:1
\$3.526 44:2 45:24 46:4	2000 32:17,20 33:7,18	30 9:23 10:4 43:19	acknowledges 14:20
<hr/>	2001 33:19	30-days 9:21	act 28:5
(2002 33:21	3:42 32:4	acted 15:1
<hr/>	2003 13:15 31:12 44:16	<hr/>	acting 24:4
(a) 46:18	2003-2015 32:13	4	action 28:8
(c) 46:21	2004 36:22 45:19	<hr/>	add 52:7
<hr/>	2005 13:15 44:16 45:21	5	additional 23:3,4 38:19,20 55:21
1	2009 24:24	<hr/>	additionally 7:6 44:25 48:24 49:14 51:7 53:23
<hr/>	2010 18:19 20:5 22:6 24:24 50:2	5 27:13,23	addresses 56:12
1 44:21 47:13 48:15 49:24 50:14 51:5,9	2013 22:23 37:13	<hr/>	adjourn 32:4
1.166-1 13:20 46:21	2014 12:8 15:4,17 16:6 20:12 21:22 22:6,14,22,24 24:10 29:11 31:13 39:6,16 40:11 41:25 43:1 44:5 45:6,23 46:2,6,9, 16 52:1 53:4,9,22 54:7 56:5	7	administrative 5:12,13 16:17 31:5
10 55:21 56:19	2015 15:6 22:18 28:15,21 49:6 50:15,18	<hr/>	admission 15:7 51:25
1099 28:24 40:7, 17 49:8	2021 29:9	8	admits 49:13
1099-C 15:18 24:8,9,10 40:10	2024 5:1,8	<hr/>	admitted 6:1 9:8, 10 26:6
13 12:19	21037435 5:6	80's 33:3	advance 23:3 47:3 51:1
15 29:9	2224 53:1	8th 50:15	advanced 23:11
166 12:10 15:12 46:18	224 28:3	<hr/>	advances 47:25
17 5:1		9	advancing 47:11
17th 5:8		<hr/>	
19 38:4		A	
1971 25:23		<hr/>	
1972 26:1		A-S 9:8,10	
		ability 20:7 51:11	

- advice** 45:10
- affirm** 7:17,25
8:17
- affirmations** 7:13
- afternoon** 6:13,
15,17 11:19 25:16
41:2
- agency** 11:23
- agree** 48:2
- agreed** 10:17
18:15 34:25
- agreement** 13:22
18:12 23:21 24:1,
4,11 26:23 27:3,7
33:18 36:23 42:16
44:20,21 47:24
48:15 49:22,24
50:5,14 51:5,9
- Agreement's**
47:13
- agreements**
10:19 11:2 12:21,
22,23 13:14,17
14:12 18:14 23:12
24:17 27:14 35:19
36:20 37:5 44:20
48:19 50:7 52:14
56:18,22
- agrees** 48:1
- ahead** 12:2 30:6
32:18 55:12
- Air** 25:22
- Alan** 6:12,14 7:2
12:6
- ALJS** 31:21
- allege** 28:10
- alleged** 10:24
44:17 45:17 49:2
50:19 51:17 53:4,
8,21,24 54:2
- allies** 47:18
- alphabetical**
10:12
- amount** 49:25
- amounts** 37:13
53:5
- analyze** 48:7
- annually** 56:5
- apologize** 32:18
- appeal** 5:6,15,21
6:21 8:25
- appeals** 5:7,22,23
11:22
- appeared** 22:25
- appears** 8:2
- Appellant** 6:10,
12,21 7:1,9 9:2,
13,23 10:22,25
12:6,9,25 13:12
14:13,18,24
15:16,18,21 16:6,
10,13 43:25 44:7,
9,19,25 45:2,5,10
46:2,5,7,13 47:13,
15 48:7,8,13,17,
19,21 49:2,8,9,13,
14,20 50:4,6,11,
22 51:2,7,18,23,
25 52:2,4,9,11,12,
15 53:3,6,23 54:4,
5 56:8,10
- Appellant's** 7:1
8:23 10:14,15
11:14 12:16 13:15
15:5 35:17 37:8,
16 42:14 45:12
46:3 48:9 52:6,17
53:1,19 54:2,19
55:19
- appellants** 54:21
55:7
- apply** 54:25 55:2,
7
- approximately**
5:9 11:13 26:15
44:2,13 45:25
46:4
- argue** 23:16
- argues** 13:3
- arguing** 14:6
- argument** 54:8
55:21
- arguments** 6:1
52:17
- arises** 46:24
- army** 21:1,3
- arrangement**
51:17 52:16
- asbestos** 17:3
- ascertain** 18:6
55:6
- asks** 43:13
- assertion** 53:20,
21
- assets** 22:6
- assume** 37:24
- Assuming** 53:5
- Assured** 27:25
- ate** 13:2
- attached** 24:12
49:24
- attempt** 23:16
- attempted** 28:14
49:16 52:25
- attempting**
28:20,22
- attend** 19:21
- attended** 19:24
- attending** 31:10
- attorney** 16:25
27:20 44:7 45:11
52:5
- attorney's** 30:11
- attorneys** 9:18
- audio** 34:14 36:9
- audit** 45:5
- authorities** 46:18
- auto** 33:25
- averaged** 39:11
- aware** 39:21
- awhile** 33:4
-
- B**
-
- B.I.** 13:5 14:16
43:2
- Bachelors** 25:21
- back** 8:14 28:23
31:23 32:6 33:3,
18 36:21 37:12
38:3,6 43:18
- background**
16:24 20:24 25:19
32:24 33:1
- bad** 6:23 12:7
16:7,10 17:3 21:7
22:12 28:25 29:14
30:17 42:2,9 44:4
46:1,10,22 49:3
53:7
- balance** 37:12
- bandwidth** 36:8,
11
- bank** 37:23
- bankruptcy**
22:10
- bar** 26:6 51:24,25
- based** 6:1 23:12
45:10 46:24 48:9
53:19
- basic** 53:2
- basis** 17:13
- bears** 47:12
- beg** 32:17
- begin** 11:13,16
30:25 32:7 43:20
55:23

- beginning** 8:15
- benefit** 19:4 28:6
30:20
- Berkeley** 26:3
- beryllium** 17:2
- Bilthouse** 53:13
- bio** 32:1
- biography** 25:18
- bit** 14:3 31:11
32:25
- blank** 50:2
- Boalt** 26:4
- Board** 6:16,19
11:8 25:7,10
40:21 43:11,19
- Board's** 41:9,15
- Boatner** 12:14
47:16,18,20
56:11,20,23
- body** 5:23
- bona** 12:12,13
13:11,19 16:5
46:14,21,23 47:5,
12,17 48:4,14,23
51:22 56:13
- bookkeeping**
48:25
- borrower** 50:24
- borrowing** 34:23
- bought** 33:8
- Brayton** 5:6 6:12,
14 7:3,14,19,22,
23 13:4 14:16,25
16:15,21 18:16
21:15,18 24:6
25:11,16 26:10
28:14 29:1,6,12
30:6 32:21 33:12,
15,20 34:19 35:12
36:20 37:10,17
38:5,10 39:3,16
40:8,10 41:25
42:6,11,16,17,20,
- 22 44:8,9,11,12,
17,23 45:1,17,19,
21,23 46:1,9
47:15 48:18,24
49:5,15 50:12,16,
18 51:3,8,14 52:6,
7,19,21,24 53:8
56:3
- Brayton's** 12:6
- break** 31:18 32:1,
4,5
- breakdown** 37:9
- briefing** 54:23
55:13
- bring** 22:3
- bringing** 17:15
18:2 22:6
- burden** 15:20,23
23:7 38:19 47:12
54:20,22 55:3,9
- business** 17:17
23:2 24:23,25
25:1 43:2,8 46:3,
6,19 52:1,15 53:2,
18,20 56:16
- businesses** 52:3
-
- C**
-
- C-U-M-B-E-Y**
21:16,17
- California** 12:10
15:12 26:7 44:7,8
46:2 51:25 55:1
- call** 12:1 25:4
- cancellation**
29:14 56:7
- Canestrelli** 6:11
7:11,22 9:3,6
10:8,10 11:4,7
16:11 25:3,9 30:1,
3,7,10,23 31:8,24,
25 32:7,9 34:9,15,
18 35:1 36:17
40:18 41:11,13
55:20,22,25
- capital** 47:4
55:21
- carry** 20:12
- carrying** 38:19
43:7
- case** 5:6 12:5
17:22 18:11 29:11
44:7 47:18,22,23
54:4,25 55:2
56:11,17
- cash** 51:6
- catch** 14:1 34:7
- caveat** 10:20
- CCK** 42:12
- certified** 21:2
- CFO** 21:7
- CFO'S** 20:24
- chance** 35:19
- change** 16:2
- characterization**
42:3
- charged** 49:13,16
- charges** 20:2
- chat** 6:7
- chief** 20:19 21:5
- choppy** 34:11
- Civil** 28:3 52:25
- claim** 12:6 16:10
44:1
- claimed** 44:4
- clarifies** 55:18
- clear** 12:19 15:7
34:17 40:5 51:11
- client** 33:13 34:24
- clients** 32:22
- close** 40:6 43:8
- closely** 47:19,21
- closer** 34:2
- closing** 43:2 45:7
- co-panelist** 41:16
- co-panelists**
54:11
- Code** 12:11 15:13
28:3 46:18 52:25
54:23,24,25
- coincided** 37:13
- collateral** 50:10,
12,13,19 51:20
52:13
- collect** 28:14,20,
22
- collectible** 22:9
54:1
- collection** 29:16
- comfortable**
35:25
- commercial** 33:2
- Commission**
56:11
- Commissioner**
12:14 47:16,18,23
56:15
- communication**
15:23
- communications**
5:25 22:20
- companies** 15:10
40:14
- company** 10:23
18:2,6,9,21 19:17
22:4 23:5 32:14,
15,16,19 33:6,9,
11,16,23 34:20,22
40:2 44:10 45:9
53:11,14,16
- company's** 15:11
17:11,12 28:18
- completely** 12:1
56:6
- complex** 19:3

computer 8:4	contacted 39:24	17:15,16	current 16:24
conceded 50:22 51:2,7	contended 50:11	correct 17:7 20:8, 21 25:23,24 26:1, 2,4,5,7,8,10,11, 13,14,17,18,25 27:1,3,16 28:21 29:3,6,7,18 37:11 39:25 43:3 47:23 56:11	cut 35:8 38:3,6
concedes 48:19 49:21 50:4	contends 44:22 45:2 46:7 47:13 52:9		<hr/> D <hr/>
concerned 35:5 38:1	contentions 48:9 53:1		date 5:8 9:21 11:3 50:1,2,8 51:10
conclude 41:11	continue 12:2 43:6	correspondence 35:10	dated 29:8 49:6 50:17
concluded 20:8 22:7	continued 20:11 27:7 52:19	correspondence s 28:18	dates 12:24
concludes 43:10 54:8	contradictions 48:10	corroborated 15:9	day 53:20
conclusion 16:4	contradictory 49:9 53:1	Counsel 54:18,19	days 9:23 10:4
condition 15:12	contrary 56:1	court 5:22 11:20, 23 21:13,17,19 34:10 35:6 47:24 53:13 54:15 55:4 56:12	dead 38:19
conduct 5:18 13:22 14:11 24:18 52:6,7	contribution 47:4	courts 48:3 53:10	debt 6:23 12:7,13 13:19 14:21 15:13,17 16:7,10 21:7,21 22:14,16, 18 23:5,8 28:17, 20,25 29:10,14, 16,21 30:13,17 35:11 37:15 38:24 39:1,2,4,15,17,23 40:1,14,16 42:2 43:7 44:4 46:10, 14,19,22,23,24 47:2,5,12,14,17 48:14,23 49:4 50:17,20 51:22 52:21 53:4,6,7,8, 21,25 54:2,7 56:5, 7,13,19,21,25
conducted 51:13	contributions 23:17	cover 40:6	debtor-credit 13:2
conference 6:25 7:1 8:23,24 9:2,12 10:16 11:6 31:10	convened 5:9	covered 42:14	debtor-creditor 14:12
confirm 7:9 9:4 13:22 15:19 55:12	conversation 39:20	CPA 21:4,11 42:8 45:11 49:1,7	debts 46:1
confirmed 7:11 24:3 54:22	conversations 23:13	CPA's 21:9 42:3	December 44:16 45:6
confirms 14:12	convert 19:6 22:16,18 23:19 39:1	CPAS 42:7	decide 5:21
conform 55:1	convertible 35:4	create 13:2	decided 23:8 29:20
Conformed 12:10	converting 14:21	credible 15:22 48:8 54:6 55:4,7	decision 5:16 9:24 16:9
connection 18:8	convinced 19:10	creditor 15:1 22:10 46:24 47:6, 14	declaration 29:13
considered 7:6 15:13 47:4	convincing 12:19	cross- examination 25:4,8,14 40:25	
consistently 15:1	copies 10:19,21 36:25 44:19	cross-examine 7:7	
consists 8:25	copy 27:10	cues 12:2	
constituted 53:5	corporate 17:18 26:24 51:15 52:16	culpability 17:23	
constructive 28:1,9	corporation 18:16 44:14 47:19,21	Cumbey 21:11,16	
consult 21:8	corporations		
consulted 21:11			

declared 29:10
declaring 21:21
declined 52:21
deduct 6:22
deducted 12:7
 56:4
deducting 21:7
deduction 6:23
 12:7,9 13:12 16:7,
 10 42:1,2,4,10
 44:4 46:10,19,22
 53:7 56:10
defendants
 17:17,18,24
defined 13:19
 46:23 47:24
definitive 38:12
degree 26:3 51:23
demonstrate
 53:16
demonstrating
 33:18
denial 12:6
deny 16:9
department's
 9:10
deployed 33:19
describing 16:23
desire 24:22
Desperate 39:8
deteriorating
 15:11
determinable
 47:1
determination
 15:16 48:3 53:6
determine 12:12,
 13 17:19 21:9
 53:12
determined
 45:11
developed 32:20
development
 19:4 32:21 33:6
difficult 37:20
direct 16:12,19
 31:7
directly 56:12
directors 35:14
discharge 39:22
discharged
 40:15,17
discharging
 39:17
discussed 9:18
 11:5 21:10 54:20
 55:13
discusses 49:7
discussing 33:14
 39:17
discussions
 22:13
display 6:5
dispute 10:17
distinction 56:13
distinguishing
 12:15
distress 15:4
distributions
 39:12
doctrine 30:21
document 35:25
documentary
 13:10,13 15:19
documentation
 42:19 56:2,9
documented
 15:17
documenting
 28:24
documents
 12:20 13:21 14:10
 35:22 36:21 37:3
 44:22
dollars 12:8 16:7
 38:20 39:11 45:20
 52:13
due 20:6 22:25
 44:3 51:5 53:25
duly 16:16 31:4

E

E-MAIL 14:17
 28:17 40:16 49:5
 50:15,17
E-MAILS 15:6
 45:1
earlier 11:22
early 15:6 22:18
economic 19:5
Economics
 25:22 51:24
effect 38:17 43:6
 45:8
effects 29:14
effort 38:17
efforts 21:22
electronically
 5:10
element 47:8
employees 38:4
end 15:3 23:18
 26:25 27:16 28:8,
 19 29:15 41:23
ended 23:24
enforce 47:11
 49:17 51:8
enforceable
 24:20 37:6 46:25
 48:18
engage 5:24
engaged 33:15
 34:20
ensure 5:20 21:22
entered 35:24
entitled 6:22
 13:12 44:1 46:10
 53:6 56:10
entitling 16:6
equal 5:17
equated 14:22
equity 12:15 13:6
 14:21 15:2 19:7
 22:16,19 23:17,19
 28:17 29:2 35:3
 39:1,2,4 50:16
 52:20 56:1,3,14
essential 47:8
establish 11:2
 46:13,15 47:16
 49:10 53:3
established 6:22
 44:1 47:3 48:17
 49:20,22
estate 33:2,6
evaluate 17:21
event 54:21
evidence 6:2 7:6
 9:11 12:19 13:9,
 13,15 14:24
 15:19,22,25 16:4
 28:17 47:14
 48:12,16 49:10,15
 50:7 53:15 54:6
 55:5,7 56:9
EXAMINATION
 16:19 30:9 31:7
examined 16:17
 31:5
exchange 14:19
exchanges 14:17
excuse 52:12
executed 13:14
 23:15 24:15 27:3,

- 4,7,15,17,23
48:22
- execution** 26:22
- exercise** 18:20
22:7
- exercised** 14:15
16:1
- exhibit** 9:13
10:14,15 14:17
15:5,10 37:9,16
48:14
- Exhibit's** 8:25
- exhibits** 8:22,25
9:3,8,10,14,15,20,
25 10:12,13 13:15
14:25 23:20 35:17
36:19 37:8
- exist** 28:2 47:6,12
- existence** 16:1
46:14 47:2,17
48:14 54:6
- expand** 19:18
20:11 33:23
- expectation**
15:14
- expectations**
39:25
- expected** 11:12
- expenses** 40:5
56:16
- experience** 21:4
26:16
- expert** 30:22
- explain** 31:11
32:13,25 45:15
- explaining** 20:24
27:22
- explanation** 42:3,
7 49:8
- exposures** 17:2
- expressed** 47:25
- extensive** 24:24
- extensively** 37:3
-
- F**
-
- F-L-E-U-M-E-R**
21:15
- facing** 56:13
- fact** 13:9 22:17
23:18 24:24 28:24
29:21 47:6,22
- factor** 12:16 18:3,
4 48:11 49:12
- factors** 12:14,18
47:16 48:4,6,8
56:23
- facts** 44:6 47:7,21
- factual** 55:5,8
- failed** 46:13,14
49:9,13 52:18
53:3
- Fair** 42:8
- faith** 47:10
- familiar** 17:14
22:4 30:20
- favor** 56:23
- feature** 12:24
- fide** 12:12,13
13:11,19 16:5
46:14,21,23 47:5,
12,17 48:4,14,23
51:22 56:13
- file** 9:22 43:1,13
- filed** 28:8 52:24
- final** 55:19,24
- finally** 15:20
- finance** 25:25
32:24 33:1,7
51:24
- financial** 15:4,11,
23 17:11,12
19:14,16,20 20:2,
7,14,15,20 21:5
22:1,21 29:12
37:9 39:7 51:3,10
54:5
- financially** 29:17
- financials** 22:5
- financing** 26:24
33:22
- find** 42:22
- fine** 11:25
- firm** 17:6,7 18:11
19:1,5 21:5 26:10,
12,16 44:9 52:6
- firms** 19:1
- Firstly** 49:20
- five-minute**
31:18 32:4
- five-year** 39:10
- fixed** 12:23 13:18
46:25 49:19 50:1,
3,8,9 56:25
- Fleming** 20:21
- Fleumer** 20:22,23
21:15 39:20 42:11
- Fleumer's** 24:16
- flow** 51:6
- focus** 15:25
- focused** 56:15
- follow** 30:3
- Force** 25:22
- forgave** 40:1
- forgive** 52:22
- form** 15:18 49:8
52:22
- formal** 40:13
- formalities** 11:24
51:16 52:16
- format** 9:15
- forward** 8:22
10:16 24:23 39:6
41:9,10,14
- founded** 26:12
- founding** 17:6
26:9
- framework** 12:15
- Franchise** 6:16,
18 11:8 25:7,10
40:21 41:9,15
43:11,19
- fraud** 28:4
- FTB** 7:7 8:25 9:8,
14,18,20 10:14
13:3 15:24 30:11
54:24 55:12,15
- FTB's** 10:13 12:6
16:9 54:18 55:25
- fully** 48:22
- function** 6:7
- fund** 45:4 47:9
48:15 52:13
- funding** 27:8
38:19
- funds** 13:3 23:3,5,
11,16 28:2,9
34:23 38:20 39:9
44:23 47:3,11
51:1 52:11
- futility** 22:7
- future** 29:11,16
30:13,18 54:1
-
- G**
-
- gain** 22:23
- gained** 28:6
- gains** 28:3
- gave** 38:22
- genuine** 47:2
- gift** 47:4
- give** 17:20 36:13
- giving** 31:10
- good** 6:13,15,17

11:19 18:25 22:12
25:16 34:25 41:2
47:10

good-faith 47:9

graduate 20:25

granted 14:14

ground 17:3

grow 24:25 34:21

guess 18:14
30:16

H

Hall 26:4

hallmarks 13:19

hand 8:21

handled 20:19

happen 22:9

happened 37:25

hard 34:12

hear 7:24 8:3
31:14 36:4

heard 5:11

hearing 5:9,11,
16,18 6:4 7:5,10
8:8 9:16,21 11:12

held 5:7 47:19,21

helps 34:5

hired 21:4

history 56:19

hold 41:22 43:12

Honor 11:19 12:1
41:13 55:3

hope 36:14 45:13
53:24

hour 11:15

hours 11:13

I

ideas 33:10

identified 55:10

identifying 9:13

implications
39:22

implied 47:25

impose 28:9

impression
38:22

inability 14:20
45:3 51:4

inapplicable
47:22

include 7:2 50:3

includes 15:6

including 14:24
17:2

income 29:13,22
30:12,15,19 40:1,
2,7 44:18 45:18

incomplete 50:2
51:18 52:14

inconsistent
53:2

incorrect 47:17

increase 34:1
36:8,11

independent
5:22 11:23

index 9:13

indication 24:21
48:4

influence 28:4

inform 38:10

information 5:20
19:14,16,20 40:8

informed 43:2

initially 32:20
37:2 40:4

injury 16:25

insolvency 45:3

instance 38:15

instrument
48:12,22 49:11,23
56:21

insurance 18:3,6

intact 45:11

intent 13:1 47:9,
10

interest 10:24
13:18 20:1,4,5
22:17 38:2 48:2,
21 49:12,14,16,17
50:1,6,8,23 51:4,9
52:18,23

Internal 46:18
54:23,24

internet 6:6

interrupt 13:25
33:25

introduce 31:11
32:12

introduces 55:4

invest 18:22

investing 18:9
39:8

investment 18:16
29:1,6 35:3 44:10,
11,12,23 45:1,8,
12 46:1,10,16
47:15 50:12,16,18
51:3,8,15 52:8,19,
21,24 53:8 56:3,4,
7

Investment's
52:7

investments
13:4,7 15:1 24:6
29:12 35:12 36:20
37:10,17 40:11
42:1,2,17 44:17,

18 45:17,18,19,
20,21,22,24,25
46:8 47:19 48:18,
24 49:3,6,15 52:3,
9

investor 15:2

involuntary 28:6

involved 19:2,22

involvement
19:25

involves 33:7

IRC 12:9 15:12,21

issuance 15:18
49:7

issue 5:25 6:20
12:5 15:3 24:6
27:25 43:25 53:19
55:5,8 56:17

issued 18:19
24:10 40:10,17
42:15 46:1

issues 12:12
33:25 34:14 36:5
51:5 56:12

J

January 49:6
50:15,18

joined 32:15,19
33:7

judge 5:5,13,14,
18 6:20 7:12,20,
23 8:14,20 9:8,12
10:3,4,7,11 11:8,
11,21,24 12:4,5
13:23,25 14:8,9
16:17 25:3,6,10
29:25 30:4,5,25
31:5,16,23 32:3,6
33:24 34:5 36:2,7,
13 40:20 41:8,14,
17,18,20,22,24
42:8,13,21,24
43:9,14,18 54:10,
13,14,15,17

55:11,17
judgement 17:25
 18:1 22:8

judges 5:12,15

Justin 6:13

K

K-1 46:2

Kamalpreet 6:15

Keith 5:12

key 12:12,13,24

Khaira 6:15,16
 10:1,3,6 11:10
 25:12,15 29:23
 40:23 41:1 43:23

kind 20:16 22:11
 34:11,12 38:18

knew 18:5

L

labeled 12:20

labeling 10:13

lacking 54:3

laid 24:24

large 52:2

largely 51:17

late 22:17

law 5:12,13 6:2
 16:17 26:3,4,10,
 16 30:21,22 31:5
 44:9 52:5

Lead 5:13

leading 39:10

legal 46:17 53:2

legitimate 56:21

lend 18:16 52:11,
 12,19

lender 51:1

lets 8:15 36:13

letter 45:5

liability 17:23
 55:6

licensed 52:4

lieu 50:16 52:21

ligation 17:17
 19:2,3

light 47:7

likelihood 22:11

liquidating 53:10,
 14

live 6:4

LLP 26:10

loan 12:22 15:8
 16:3 18:23,24
 19:6 28:15 33:14
 35:3,23 38:5,11,
 13,21,23 43:7
 45:14 47:20,24
 48:5 49:3 51:1,12,
 14 52:19

loans 10:24 12:24
 13:11 16:5 20:2
 23:12,17,19 46:8
 47:18 49:7 50:25
 51:16 52:9

locate 24:17 37:4

long 5:5,12,14
 6:20 7:12,20,23
 8:14,20 9:8,12
 10:3,4,7,11 11:8,
 11,21,24,25 12:5
 13:23,25 14:8,9
 25:3,6,10 27:18
 29:25 30:4,5,25
 31:16,23 32:3,6
 33:24 34:5 36:2,7,
 13 40:20 41:8,14,
 20,22,24 42:8,13,
 21,24 43:9,14,18
 54:10,15,17
 55:11,17

longer 15:8 24:16
 40:15

looked 35:21
 37:12 42:23

lose 38:8

loss 15:9 20:17
 44:2 45:24 46:6
 53:7

losses 40:3,7
 46:4

lot 33:4

lower 8:20

LP 44:8

lumps 12:15

M

made 9:24 15:16
 20:4 21:22 22:19,
 22 23:18 28:23
 44:12,15 49:21
 50:21,23

maintain 51:15

make 14:1,5 29:5,
 12 39:24 43:20
 51:4 52:14,18
 55:21

making 38:16
 48:3

management
 13:1 18:11 19:22,
 25

managing 14:13
 26:16 32:22

March 44:16

mass 19:2

masters 25:25
 51:24

match 37:24

Matt 20:21,22,25
 39:19

matter 5:7

Matthew 6:18

maturity 11:3
 12:23 50:1,8
 51:10 56:25

meantime 8:11

meet 5:16 15:5
 54:21

meeting 19:24
 36:9

meetings 19:22
 35:14

members 5:15

memorialize
 35:23

mentioned 33:12

met 33:19 34:19
 48:7

microphone 8:2,
 4,10 31:17 34:2,3
 36:5

Miller 6:17,18
 10:1 55:2

million 44:2,13
 45:22,24 46:4
 51:5,19 52:13,23

millions 38:19

mind 16:23 20:23
 55:18

minimal 22:23

minute 43:12

minutes 6:4 8:8
 32:2 43:19 55:21

**mischaracterizat
 ion** 13:8

**mischaracterize
 s** 13:9

mistake 28:4

moment 43:10,15

money 17:20
 18:16 22:12 40:5
 47:1,25 52:20

monies 37:18

move 41:8,10,14
55:19

moving 8:22
10:16 14:3

muted 8:4,5 31:14

N

names 6:9

Natasha 5:14

nature 16:2 35:15

needed 5:20

negligence 17:22

negotiating
33:17

non-issuance
42:18

nonsensical 56:2

note 10:18 12:21
13:14,16 18:18,19
23:20 24:12 26:22
27:2 35:4,5,8,9,18
36:1,19 44:19
48:12,13,14,16,
17,22 49:10,22,24
50:3,14 51:5,9,19
56:17,18,22

noted 11:22 50:4

notes 10:20 11:1
12:20 13:18 15:22
18:15,17 22:25
24:15,17 25:1
27:15,23 28:1
37:1 38:2 42:15
45:13 48:20 50:6
52:14 56:25

notice 35:13

notified 40:16
45:6

November 50:1

Number 49:19
50:10,21,24 51:13

O

oath 7:6

objection 9:6,7

objections 9:3,5,
9,19,22,24 10:9

obligation 35:11
46:25

obligations 15:5
51:12

occupation
16:24

occurred 37:21,
23 39:20

October 29:8

offer 25:7 29:2
50:19

offered 22:15
28:16 50:15 52:20

offering 22:18

offerings 33:3

offers 23:19

Office 5:7,21
11:22

officer 20:20 21:5

officers 28:18

offset 40:3

omission 54:2

one-page 20:16

opening 5:5
11:14 16:11
26:20,21 27:12,
20,23 28:12 41:12
42:14

operate 43:6

operating 33:10

operation 34:24
40:5

operational 41:4

opinion 6:1

opportunities
22:15

opportunity 7:7
10:9 23:4 25:8

opposed 42:2

opted 50:19
52:11,12,22

option 14:15 36:9

oral 7:5 9:16,21

order 29:13

ordinary 45:24
46:3 56:16

originally 35:24

OTA 5:6,25 8:9
9:15,22 31:18

OTA'S 55:10

outline 44:6

outlined 55:8

outlines 13:17

outset 18:5 19:15

overhanging
23:5

oversaw 32:20

overwhelmingly
12:16

owed 53:8

owned 33:16 44:3

owning 26:16

P

p.m. 5:2,9

paid 30:18 49:18

panel 5:11,15,19,
24 16:9 31:21

paperwork 40:13

pardon 32:17

part 18:19 34:11
35:7 38:25 39:2
47:10

parte 5:24

partially 28:16

participants 5:17

participate 5:19
12:25

participated
14:13

parties 6:8 10:12
13:22 14:11 48:2
51:13

parties' 6:1

partner 17:6 26:9
32:19 44:8 52:5

party 5:25

pass-through
44:2 46:5

pause 8:7

pay 10:24 25:1
28:16 38:21 46:25
48:23 49:10,13

payment 21:24
50:11,13 51:21

payments 20:1,4,
5 22:1 49:17 51:4,
8 52:18

penalty 49:1

percent 49:25

perfect 12:4
20:23

period 33:8 39:10

periodically
19:20 51:2

perjury 49:1

person 7:21 28:7
32:23 47:10,25
52:1

personal 16:25
46:6

- pertinent** 44:6
47:7
- petitioner** 47:21
- phone** 36:9
- Pietro** 6:11
- place** 54:21
- plans** 22:14 24:25
- platform** 33:23
- plenty** 34:13
- point** 20:25 22:5,
12 33:19 39:7,9,
10,16,18 52:12
- portfolio** 52:2
- position** 12:17
29:2 39:2,4 46:11,
12 50:16 52:20
55:25
- possibilities**
34:22
- possibility** 29:16
39:14 54:1
- potential** 53:11,
15,25 54:3
- practice** 17:10
26:24 53:2
- prehearing** 6:25
7:1 8:23 9:2,12
10:16 11:5
- prepared** 27:20
35:23 42:12 48:25
- present** 7:10
- presentation**
11:14,18 41:9,12,
15 43:20,22 54:19
55:9
- presents** 15:22
- president** 14:18
32:14 33:9 45:7
- pretty** 22:4 32:11
35:25 40:5,6
- previously** 12:5
50:4
- primarily** 17:1
39:19
- principal** 29:5
38:2 49:25 50:22
51:9
- prior** 18:9 21:6
22:14
- pro** 6:22 46:3
- problem** 32:3
- proceed** 30:2
- proceeding** 18:7
55:4
- Proceedings** 5:1
- process** 32:22
33:17
- produce** 5:16
- produced** 16:16
31:4 51:18 55:7
- product** 18:25
19:4 32:21
- production** 42:4
- professional**
16:23
- profit** 15:9 20:17
- program** 8:5,6
- projections**
19:16
- promise** 24:12,
14,20 48:11,23
49:10
- promissory**
10:20 11:1 12:20
13:18 15:22
18:15,17,18,19
23:20 24:12,15
25:1 26:22 27:2,
15,23 28:1 42:15
48:20,22 49:24
50:6,14 51:19
52:13 56:22
- proof** 15:20 17:25
54:22 55:3
- proposal** 14:23
28:23
- proposals** 38:16,
25
- proposes** 14:20
- prosect** 23:6
- prospect** 34:25
50:25
- protest** 42:18,19
- protested** 42:17
- proved** 56:20
- provide** 10:22
11:1 12:14,19
15:24 18:23
19:13,18,20 27:8
37:23 52:10
- provided** 9:13
18:24 19:15 22:21
23:14 27:2 35:17
44:19,21,25 45:5
48:21 49:8,14
50:7,8 51:3 54:6
- providing** 18:10
- proving** 47:12
- provision** 50:13
- provisions** 51:21
- prudent** 15:16
19:11
- public** 21:2
- Purcell** 26:10
44:8
- purchase** 12:21
13:17 26:23 27:3,
14 35:19 36:19
44:20 56:1,3,18
- purchased** 10:18
13:14 34:20 56:22
- purported** 46:7,8,
15 47:20 51:16
52:8,19
- purportedly**
44:12
- purposes** 46:22
56:7
- pursue** 40:15
- pursued** 14:16
-
- Q**
-
- qualifies** 46:22
- quality** 33:25
- quarter** 28:15,21
- question** 27:12,
22 29:1 30:7,11
36:18 37:2 38:8
40:3 41:3 47:6
54:17
- questions** 5:19
25:2,11,18 26:20
29:24 30:5,6,24
40:19,21 41:7,17,
18,21,23,25 43:10
54:12,13,14,16
55:15,18
- quick** 8:7 14:3
31:18
- quickly** 11:21
34:22 35:21 42:25
- quote** 26:21,25
27:13,16,24 28:8,
13,19 29:9,15
- quotes** 27:19
-
- R**
-
- raise** 7:15 8:16
- Ralston** 5:14
41:17,18 54:13,14
- rarely** 17:24
- rata** 6:22 46:3
- rate** 48:2 50:1,8
- reach** 8:9 31:18
- reached** 19:12
- read** 25:17

ready 11:16 31:1
 32:8 43:20 55:23
real 11:21 21:4
 33:2,6
reason 23:10
reasonable 15:14
 21:9 50:25
reasoned 53:14
rebut 15:25
recall 24:16
 37:11,18 42:20
receipt 47:9
receipts 38:5,6
receive 21:23
received 9:14,15
 25:21,25 26:3
 50:12 51:24
recommended
 42:9
record 5:5 6:8
 8:12,13,14 20:1
 27:21 31:22,23
 32:6 43:15,17,18
recorded 20:5
records 15:23
 20:3 48:25
recoup 56:6
recover 53:24
recovered 29:11
recovery 38:18
redeeming 45:13
REDIRECT 30:9
reenforcing 13:1
refer 10:13,14
 35:9 44:10,15,20
reference 26:19
 27:19
referred 13:4,6
 35:5,7
referring 18:15
refers 55:3
reflect 23:21
 36:23 37:18,22
reflected 37:15
reflects 24:1
 29:19
refused 29:2
refutes 53:21
regard 53:18
regular 17:13
 26:23
Regulation 13:20
 46:21
regulations
 55:10
rejected 50:18
related 20:2
relating 45:25
relationship 13:2
 14:12 46:24 47:6,
 14
released 45:8
relevant 6:2
 46:17 55:5
relies 47:15
rely 42:7
remains 53:20
remember 37:20
reminder 5:21 6:3
 7:4
Remote 5:1
repaid 30:13
repay 14:20 15:8
 20:7 24:13,14,20,
 22 29:21 38:1,11,
 13,22 45:3 47:9
 48:1,12
repaying 39:15
 50:25
repayment 13:18
 15:5,15 19:13,18
 22:13 38:1 47:11
 49:22 50:3,9
 51:20 52:22,25
repayments 29:5
 49:20,21 50:21,22
repeat 35:6 36:3,
 15
repeatedly 21:25
 24:22
reply 53:23
reported 44:17
 45:16,17,20,21,24
 46:2,5
reporter 21:13,
 17,19 34:10 35:6
 43:13
reports 52:8
represent 6:9,12,
 14,16,18
representative
 42:17
representatives
 6:10 45:1,2
representing
 17:1
request 6:6
requested 43:11,
 12,19 55:20
required 7:5
 30:14
resolved 47:7
resort 14:21
respect 10:11
 11:25 28:2 41:25
 42:13,15 51:16
 55:5,8
respectfully 16:8
respond 9:24
 10:9
Respondent
 6:16,18
Respondent's
 46:11,12 54:8
response 29:8
responsible 14:4
restructure 38:23
restructuring
 22:14 39:1
result 28:1
resume 22:1
retired 21:1
return 41:25 42:5
 44:18 45:16,19,
 21,23 46:6 52:1
returned 31:20
returns 13:18
 42:12 48:25
Revenue 12:11
 15:12 46:18
 54:23,25
reverse 16:9
 29:13
review 9:17,20
 35:19
reviewing 51:10
Richard 7:3 22:15
 29:19
right-hand 8:16
right-hands 7:15
rights 14:14
Robert 33:4
Rodriguez 14:1
role 31:12 32:13
room 31:20
roughly 31:12
rule 30:20
rules 55:9

S

S-CORPORATION

44:3,10 56:4

S-corporation's

44:4

S.i.s 18:19,23,24
19:23 22:3,20
23:11,16 44:15,24**S.i.s's** 51:4**S.I.S.** 13:1,6 14:1315:4,7 19:25
21:24 27:3,25
28:9,15 29:3,5,11,
17 31:12 32:13
33:8,13,14 35:13
36:20 37:10,17,19
38:1 39:7,22 40:2,
11 41:4 45:2,7,12,
13,20,22,25 46:8
47:15 48:15 49:6,
13 50:15,16 51:2,
11 52:18,20,21,25
53:8,18 54:5**S.i.s.'s** 14:18,20
29:2 45:3 50:18
51:10**salary** 39:9,10**satisfy** 51:12**schedule** 46:2
49:19 50:3,9
51:20**School** 26:4**Science** 25:21,25**scoot** 34:1**screen** 6:5**secret** 56:1**Section** 12:10,11
15:12,13,21 28:3
46:21 53:1 54:23,
25**secure** 50:11,12
51:20 52:25**securitizing** 33:5**security** 48:21
50:6**sell** 28:16**send** 35:13**senior** 26:9**sense** 22:19
52:15**sentences** 36:3**September** 5:1,8**series** 13:13
35:18 44:25 48:9**served** 21:1**setting** 54:23**seven-year** 18:18**severe** 15:4**share** 6:23 46:3**shared** 40:8**shareholder**
14:14 19:21,24
35:13,14 44:9
56:4**shareholders**
39:12**sheet** 37:12**shifting** 54:20**shifts** 15:23**short** 32:5 33:8**show** 13:11,21
14:11,25 15:10,11
16:4 17:22 24:25
42:1 54:6**showed** 51:4**shown** 56:8**shows** 52:2 56:9,
19**sic** 13:10**sides** 37:1**signed** 18:1223:21,22,23,24
27:10 36:20,21,25
49:1**significant** 36:5**silica** 17:2**single** 48:21
51:18**situation** 10:2
39:7 56:12**slow** 14:2**slowly** 34:16**software** 10:23
13:5 18:11 33:17,
18 34:21 44:14**sole** 44:9**solutions** 10:23
13:5 44:14**solvencies** 17:11**solvency** 17:13**sophisticated**
52:1,2**sought** 12:9**source** 19:18**speak** 22:2 34:11,
16 46:17**specifically** 55:9,
13**specifies** 49:25**spelling** 21:14**spent** 40:4**Spies** 7:3,14,15,
23 8:7,15,19
14:18,19 15:7,19
18:9,13 24:19
28:23 31:3,9,14,
16 32:10 33:24
34:4,7,13,16,19
35:9 36:2,6,12
40:22 41:2 42:25
43:4,5**staff** 38:4,6 45:8**standard** 55:3**start** 8:15 14:23
33:14 36:10 39:17
43:13**started** 6:4 33:5**starting** 6:9**state** 6:8 26:6,21
27:13,24 28:12
29:9**stated** 12:5 45:6,
10 48:3**statement** 7:1
8:24 15:10 16:12
28:19 29:15 38:13
55:19,24**statements** 20:8,
14,16 22:2,21
27:19 37:23 49:9
51:3,11**States** 25:22
53:13**status** 19:14**Statute** 13:20**staying** 34:2**stepped** 31:25**stock** 18:21**streamed** 6:5**strength** 17:21**strict** 17:23**structured** 18:13,
17**subsection** 46:18**subsequent**
50:17**substantial** 39:2**substantially**
38:7**substantiate**
44:22 45:3 48:13
49:15**substantiated**

54:4
substantiation 52:10
successful 17:7, 9 29:20 34:24
sue 17:16,24
sufficient 15:24 51:1
suggest 36:9
suit 17:19 18:3 22:3,6 52:24
suits 17:15
sum 47:1
summary 20:16
supervising 44:8 52:5
supported 10:19, 21 48:20 50:5
supports 12:16 14:19 48:23
suppose 33:21
supposedly 54:20
swear 7:17,25 8:17
sworn 16:16 31:4

T

taking 24:23 39:9
talk 14:24 21:8
talking 28:24
tax 5:7,15,21,22 6:16,19 11:8,22, 23 12:11 25:7,10 30:20,21,22 39:21 40:21 41:9,15 43:11,19 44:18 45:16,18,23 46:1, 6 48:25 52:1 53:4 54:7 56:7

taxable 46:20
Taxation 15:13
taxpayer 47:11 55:4,6
taxpayer's 11:14
technology 32:23
terms 12:21 48:1
Terry 21:11
test 56:20
testamentary 13:10
testified 16:18 31:6
testimony 13:10
testimony 7:4,5, 10 11:15 15:18 16:13 25:5 31:10 56:2,9,18
Texas 44:14
thing 19:11 28:6
things 17:4 36:15
thought 18:24,25 19:3,17 27:6 32:1 33:22 34:24
throwing 22:12
till 41:23
time 5:8 9:5,16,19, 20,25 10:5,21 21:2 23:9 27:18 29:22 31:19 33:8, 16,20,21 35:23 41:18 48:2 55:16
timely 9:13
today 6:25 9:15 25:17 32:10 34:14 41:3,4 43:25
today's 5:8,11 6:4 11:12
Told 34:21
tort 19:2

totaling 44:13 45:20,22
toxic 17:2
track 38:8
trained 52:4
transact 52:15
transaction 51:14
transactions 16:2 37:10,21
transcript 14:4
transferred 13:3 14:22 28:3,10 45:4 53:5
transfers 13:11 16:5 24:3 37:17 44:13,15,18,23 45:15,18 46:7,15 49:2 52:8
Treasury 13:20 46:20
treat 30:19 35:12
treated 24:5
trouble 31:17 54:5
trust 28:2,5,9
trustee 28:6
truth 7:17,18,25 8:1,17,18
Tucker 6:13,14 9:4,7 10:7 11:4,19 12:4 13:23,24 14:7,10 16:20 21:20 25:2 30:1 31:25 41:11 55:20
Tuesday 5:1
turn 23:1 36:7 41:16 54:11
turning 36:10
turns 53:7
type 42:19

typical 32:23
typically 12:22

U

UC 26:3
UCLA 26:1
un-mute 7:16
unable 11:1,2 15:4 37:4 38:3
uncollectible 49:7
undergraduate 51:23
underlying 17:22
understand 10:8 36:16
understanding 6:24 10:2 11:5,7,9 30:14,16 35:2 36:23 37:5 39:25 43:1
Understood 10:10
undocumented 51:17
undue 28:4
unexecuted 51:19
United 25:22 53:13
unnecessary 12:1
unpayable 56:6
unwilling 23:3
updated 19:20 20:15
utilized 18:11

V

valid 24:4,5 46:25

48:18
validity 48:17
variety 17:3
vendor 18:10
venture 33:4
Veronica 5:14
 41:22 55:11
verses 39:4 47:18
 56:16
viability 19:5
viable 18:7,25
 19:1 29:12,17
victims 17:1
video 36:8,10
viewed 35:10
violation 28:5
visited 25:17
vote 35:14

W

wait 8:24 56:5
waiting 31:20
wanted 55:12
warrant 10:18
 26:23 35:18 36:19
 44:19 56:18
warranted 13:17
warrants 14:15
 16:1 18:20 23:14
 28:1
warranty 12:21
 13:14
watched 22:5
water 17:3
website 25:17
Welch 47:23,24
 56:15
West 20:25

wholly 44:3
wildly 29:20
wire 24:3 37:17
 44:12
withstanding
 29:20
witnesses 6:24
 7:2,8
Worked 33:3
working 8:3
works 36:14
world 21:4
worthless 15:14,
 17 16:6 21:21
 29:10 46:9,16,20
 53:4,9,12,16,22
worthlessness
 15:3 54:7
write 23:8 39:2
 42:9 50:19
writing 21:6 42:18
written 5:16 11:1
 29:21 45:12
wrong 8:24 30:17
wrongful 28:5

Y

year 12:8 20:16
 39:11 44:4 46:1,
 20 53:4,12,17,19
years 17:1 19:19
 21:1,3 22:22,25
 24:2 26:15 31:12
 52:5 54:7 56:19

Z

Zoom 6:7 8:5