UNITED STATES BANKRUPTCY COURT
EASTERN DISTRICT OF KENTUCKY
LEXINGTON DIVISION

IN RE: CHAPTER 7

WILLIAM JOSEPH SANTIAGO and
STEPHANIE S. SANTIAGO CASE NO. 08-53141

DEBTORS

RICHARD F. CLIPPARD,
U.S. TRUSTEE,

PLAINTIFF

V. ADV. PRO. NO. 09-05078

WILLIAM J. SANTIAGO and
STEPHANIE S. SANTIAGO

DEFENDANTS

MEMORANDUM OPINION AND ORDER

This adversary proceeding arises out of a complaint filed by the Plaintiff, Richard F. Clippard, United States Trustee, Region 8 ("U.S. Trustee"), against the Defendants, William J. Santiago ("Debtor-Husband") and Stephanie Santiago ("Debtor-Wife"), the above named-debtors ("Debtors"), objecting to their general discharges under 11 U.S.C. § 727(a)(2)(B), (a)(3), (a)(4), and (a)(5) ("Code § ___"). The amended complaint (Doc 2) had 26 Counts. Prior to trial the parties entered into agreed orders dismissing all but ten Counts (Docs 113, 119, & 120), leaving the

remaining Counts–5, 8, 11, 12, 13, 14, 16, 21, 24 and 26–to be considered at trial–eight under Code §§ 727(a)(4), one under (a)(2)(B), and one under (a)(3).[1]

This Court has subject matter jurisdiction under 28 U.S.C. §§ 1334(a)-(b) and 157(a), and this is a core proceeding under 28 U.S.C. § 157(b)(2)(A) and (J). Pursuant to this Court's pre-trial order (Doc 110), the parties introduced all of their evidence-in-chief by affidavits, production of exhibits, joint stipulations and trial briefs, and the Court conducted a trial on May 14, 2010, at the conclusion of which the Court took the matter under submission (Doc 156). Subsequently, agreed orders were entered regarding U.S. Trustee's objections to some of Debtors' affidavits, including the affidavit of W. Thomas Bunch, Debtors' bankruptcy attorney, ("Bankruptcy Counsel") (Docs. 160 & 166). The court notes that the testimony at trial, particularly that of Debtors, provided much of the information stricken by agreed order that was in the affidavit of Bankruptcy Counsel (Doc. 160 and Doc. 150, Exhibit 4).

Having carefully considered the testimony of the witnesses adduced at trial, evidence from the trial affidavits, the exhibits and the stipulations, arguments from the parties' written trial briefs, and the entire record, the Court makes the following Findings of Fact and Conclusions of Law, in accordance with Federal Rule of Bankruptcy Procedure 7052.

I.

FACTUAL BACKGROUND

In 2007 Debtor-Husband resigned his position as an executive with Lexmark to pursue the martial arts business in a company formed with Warren Hatton ("Hatton"), which they named

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[1] After trial U.S. Trustee elected to drop Count 14. Therefore, this Count, brought under Code § 727(a)(3), will not be discussed here.

Sanhatton, LLC d/b/a American Fight League ("Sanhatton" or "AFL"). Debtor-Husband had extensive business experience, and Hatton had fight-level expertise.

In order to buy the AFL franchise, Debtors borrowed money against their residence, granting their lender a subordinate third mortgage. As business contacts increased and fight bookings began to develop, Debtors went to Community Trust Bank ("CTB") and obtained a business loan through the Small Business Administration ("SBA"), rewriting their subordinate second and third mortgages into one second mortgage in favor of CTB-SBA. The loan proceeds went into the Sanhatton corporate bank account, required to be maintained at CTB, and were used for Sanhatton business expenses.[2]

Sanhatton was a cash-based business: large sums of money, *i.e.*, sometimes $200,000 at a time, were required to contract fighters; to pay arena bookings, office expenses, lodging and travel expenses; and to cover payroll obligations. To satisfy growing cash needs, Debtors stated that they deferred much of their salaries, with the hope that Sanhatton eventually would have the funds to remunerate them for their time and services. Debtors drew from and substantially reduced their savings, retirement accounts, and IRAs to obtain cash for the use, and survival of, Sanhatton; traded in their personal vehicle for a business car, so Sanhatton could have a company car for AFL purposes; borrowed money personally for use in the business; and used multiple personal credit cards to pay business expenses, for which they would later obtain partial, but not full, reimbursement from Sanhatton.

In late 2008 the company's cash needs were accelerating, but its cash income was declining, and by August-September of 2008, Debtors knew the business was failing. During October 2008,

[2] Affidavit of Larry Forester (Doc 135).

Debtors and their corporate attorney, Mason Miller ("Miller"), attempted to merge Sanhatton with a New York City hedge fund, but, Debtors testified, the national bank crisis in late 2008 scuttled the merger attempt.[3] As the result of referral from Miller, they began working with Bankruptcy Counsel in November 2008.[4]

During their initial conference with Bankruptcy Counsel, Debtors stated that the business essentially had become dormant; that they had run out of money and sources of money; that bills continued to come in; that expenses, such as rent and car lease payments, were mounting; that Debtor-Husband had gone back to work at Lexmark,[5] at a substantially reduced salary; and that Debtor-Wife was unemployed. They needed some sort of bankruptcy assistance.

According to Bankruptcy Counsel, he discussed with them the possibility of filing for bankruptcy relief under chapter 7 and chapter 13. However, chapter 13 relief was quickly eliminated from consideration when Debtors' Schedule J showed a monthly net income of negative $1,505.95. Even if they could reduce their personal expenses by $1,075/month, Debtors would be about $530/month underwater. Even if they proposed a $500/month payment for 36 months, an $18,000 Chapter 13 payback, that would be only a 1.0% payback to creditors on $1.38 million owed, not the substantial payback required by Code § 707. Bankruptcy Counsel concluded that filing for bankruptcy relief under chapter 13 was not an option for Debtors.[6]

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[3] Joint Stipulations (Doc 121) ("Jt. Stips.") at paras. 29-30.

[4] Affidavit of Stephanie Santiago ("Mrs. Santiago") (Doc 146) at pp. 1-3, paras. 3-13.

[5] Jt. Stips. at para. 34.

[6] Affidavit of W. Thomas Bunch ("Bunch") (Doc 132) at pp. 2-4, paras. 4-6; Affidavit of William J. Santiago ("Mr. Santiago") (Doc 147) at pp. 1-4. Although not argued in Debtors' Trial Brief, Debtors' unsecured debts exceeded the monetary cap set forth in Code § 109(e), thereby precluding a chapter 13 filing.

On the other hand, according to Bankruptcy Counsel, chapter 7 was considered a realistic option. Although Debtors, given the reimbursements and salary payments from Sanhatton to them, would not qualify initially under the Means Test required by Code § 707(b), Bankruptcy Counsel believed that the Special Circumstances Test might qualify them for a chapter 7, notwithstanding the Six-Months Income Test. Bankruptcy Counsel also believed, considering Debtors' business-consumer debt ratio, that they might qualify for a business chapter 7, thereby bypassing the Means Test altogether.[7]

Bankruptcy Counsel and Debtor-Wife began consideration of a business bankruptcy by reviewing Debtors' various debts. First, according to Bankruptcy Counsel, he reviewed the $360,000 CTB/SBA loan. After determining from Debtor-Wife that CTB had required payment of the two subordinate residential mortgages as a pre-condition to underwriting the SBA loan, Bankruptcy Counsel opined that the full bank debt was business-related and classified it as such. Next, Bankruptcy Counsel reviewed the farm loan of $168,000 and after concluding that the purchase was made for investment and use by AFL fighters, he classified the debt as business-related. Bankruptcy Counsel then reviewed Debtor-Husband's personal guarantee of the corporate business premises lease. Bankruptcy Counsel classified that debt as business-related and calculated the breach of lease damage against Debtor-Husband to be $48,300. Bankruptcy Counsel then reviewed the Lexus lease in the corporate name, guaranteed by Debtor-Husband, and classified that debt of $40,400 as business-related. Bankruptcy Counsel reviewed the Miller & Wells law firm bill of $43,207.80 for corporate legal work, billed to the Debtors, and classified that debt as business-

[7] Affidavit of Bunch, supra at pp. 2-3, para. 5. Code § 101(8) defines "consumer debt" as a "debt incurred by an individual primarily for a personal, family, or household purpose." Code § 101(8). A debt incurred either in business, or in a business or for the business of making money is a business debt.

related. Bankruptcy Counsel reviewed the advertising work done for Sanhatton by Coomer, billed personally to Debtor-Husband, and classified that debt of $13,806 as business-related. Lastly, Bankruptcy Counsel reviewed the LDM (Larry D. Meyer) television services debt of $16,849, incurred personally by Debtor-Husband for Sanhatton, and classified that debt as business-related.[8]

At that point, according to Bankruptcy Counsel, he determined that over 50% of Debtors' debts should be classified as business-related, deemed further calculations immaterial, and concluded that he could file a business chapter 7 without violating Code § 707(b).[9]

According to Bankruptcy Counsel, he and Debtor-Wife then commenced preparation of the Petition and Schedules. Since Debtor-Husband had returned to work, Debtor-Wife met multiple times with Bankruptcy Counsel, supplying requested documentation. Per Bankruptcy Counsel, he and Debtor-Wife worked many hours during November 2008 to organize Debtors' and Sanhatton's finances on the Petition and Schedules that were filed.

Debtor-Husband did little to assist in the preparation of the Petition and Schedules because he was working full-time, and his job required out-of-state travel. Bankruptcy Counsel represented that on the day the Petition and Schedules were executed, he went over the documents in detail with Debtors and made some corrections, after which they signed the documents, based on Debtor-Wife's representation to Debtor-Husband that the information in the Petition and Schedules was correct. Bankruptcy Counsel insists the information contained in the Petition and Schedules was the result

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8 Ibid.

9 Id. at paras. 4-6.

of his legal knowledge and bankruptcy experience, in his effort to present accurate Petition and Schedules. On December 1, 2008, Debtors filed a chapter 7 business bankruptcy.[10]

As a consequence of bankruptcy, Debtors forfeited their residence (Doc 18, main case) and their farm (Doc 13, main case), while retaining an older model Jaguar automobile, their household goods, and their remaining retirement funds of about $38,000. Debtors reaffirmed the Hyundai automobile debt obligation (Doc 13, main case). They forfeited the company-leased car they had obtained by using their personally-owned vehicle as a trade-in (Doc 66, main case). Debtor-Husband already had returned to his old job, at a reduced salary, and Debtor-Wife sought employment.[11]

Debtors appeared at the Section 341 Hearing in December 2008. Panel Trustee Anna Johnson ("Johnson"), who was assigned to the case,[12] cross-examined Debtors concerning their business and consumer debts. Although she appeared satisfied at the hearing, she required certain personal assets to be re-valued, which was done (*See* Doc 11, main case). On December 29, 2009, Bankruptcy Counsel sent Johnson additional documents, namely the Hyundai title certificate and CTB-SBA loan closing statement. On February 25, 2009, Johnson filed a No-Asset Report (Doc. 20, main case), which she withdrew on March 27, 2009, apparently at the direction of U.S. Trustee (*See* Doc 27, main case). On March 25, 2009, according to Bankruptcy Counsel, Johnson emailed him that she needed to visit Debtors' residence, because U.S. Trustee had requested she do so.[13]

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[10] Id. at pp. 4-5, paras. 7-8; see Affidavit of Mrs. Santiago, supra at p. 3, paras. 12-13.

[11] Affidavit of Bunch, supra at pp. 4-5, para. 9.

[12] Jt. Stips. at para. 62.

[13] Debtors' Trial Brief (Doc 153) at Exhibit 4.

Prior to Johnson's decision to close the case as a No-Asset Case, U.S. Trustee had commenced his Code § 707(b) investigation by telephone, email requests to Bankruptcy Counsel, and deposition notices (Docs 26, 30, 33, 34, 41 & 42, main case). Bankruptcy Counsel responded by delivering documents.[14] U.S. Trustee countered that the delivered documents were not responsive. Bankruptcy Counsel presents that he requested U.S. Trustee be more precise in the document requests. More requests were made, and more documents were produced, to which U.S. Trustee replied "still not responsive." Per Bankruptcy Counsel, he insisted that he be given direction as to what the investigation was about so he could be more responsive to the requests, and was told that U.S. Trustee was conducting a Code § 707(b) analysis because personal credit card charges could not be classified as business-related.[15]

According to Bankruptcy Counsel, he advised U.S. Trustee that Debtors used personal credit cards to charge business expenses that had been or would be reimbursed by Sanhatton and that he had determined that even if one deducted all credit card charges from the business-consumer calculations, Debtors still exceeded 50% of business debt, as required by Code § 707(b). Ultimately, U.S. Trustee requested that Bankruptcy Counsel meet with his Trial Attorney and Certified Public Account ("C.P.A."), both of whom instructed Bankruptcy Counsel to obtain monthly billing statements for each credit card company dating back to when the account balances were zero and to subsequently document, on a monthly basis, which items were charged for business purposes and which items were charged for consumer purposes.[16]

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14 Jt. Stips. at para. 67.

15 Id. at p. 5, para. 11. See also: E-mail Threads attached to Debtors' Trial Brief (Doc 153) at Exhibit 5 thereto.

16 Affidavit of Bunch, supra at p. 6, para. 12.

Instead, Bankruptcy Counsel advised that Debtor-Wife had kept monthly business expense worksheets, spreadsheets, for each month for each credit card. Debtor-Wife had prepared these credit card business expense worksheets throughout 2008 in order to reflect business debts charged on Debtors' personal credit cards that could be reimbursed by Sanhatton and used by Sanhatton for corporate tax deductions. Bankruptcy Counsel represents he advised U.S. Trustee that he could prepare a chart showing the breakdown of business-related credit card charges and consumer-related credit card charges, including his illustration of the dichotomy between all other business debts and consumer debts, and was told that this kind of division chart would be helpful.[17]

According to Bankruptcy Counsel, he and Debtor-Wife spent several hours putting together the Division of Business/Consumer Debts ("Division Chart").[18] They analyzed the business expense worksheets, reviewed credit card statements, and added documents to the chart that showed the other business expenses. Bankruptcy Counsel asserts that he primarily made the business-consumer debt determinations, and that wherever there was doubt as to classification, he determined the debt to be a consumer expense debt.[19]

After putting together the chart, Bankruptcy Counsel then recalculated the consumer-business debt ratio. The Division Chart showed and Debtor-Wife testified that Debtors' calculations indicated that 73.3% of their debts were business-related.[20] Debtor-Wife and Bankruptcy Counsel

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[17] Id. at para. 13.

[18] Jt. Stips. at para. 68; see Division Chart at Debtors' Exhibits (Doc 145) pp. 1447 et seq.

[19] Id. at para. 14; see also Transcript of Trial ("Transcript") (Mrs. Santiago) (Doc. 168) at p. 150, lines 3-19. Debtor-Wife testified at the trial about Bankruptcy Counsel: "You grilled me. You grilled me. . . . We went through pretty much a credit card per night. . . . we separated everything. . . . That [if] I notated that it was business related, you didn't put it in the business column. You put it in the personal column." Transcript (Mrs. Santiago) p. 150. From the record, it appears that Debtor-Wife provided Bankruptcy Counsel with sufficient information for him to separate the business and consumer debts.

[20] Id. at para. 17.

worked extensively on the Division Chart, with Debtor-Husband providing some advice and insight by telephone, although not actively participating in its formulation. Debtor-Husband reviewed and agreed to the final work-product, based upon Debtor-Wife's explanations that Bankruptcy Counsel and she had done extensive work on the Division Chart and that it was accurate.[21] Debtors signed the Division Chart's affidavit.[22] The Division Chart later became the basis of U.S. Trustee's objection to discharge under Code § 727(a), alleging false oaths.

Bankruptcy Counsel stated he asserted to U.S. Trustee that the Division Chart demonstrated mathematically there was no way U.S. Trustee could show any division of debts causing consumer debts to be greater than the business debts, thus precluding a violation of Code § 707(b). On March 10, 2009, an agreed order was entered in the record of the main case acknowledging that the time to file a Code § 707(b) objection had lapsed, but allowing U.S. Trustee the right to seek Code § 727 remedies (Doc 24, main case). As far as Bankruptcy Counsel is concerned, the agreed order has eliminated from this case any consideration of a violation of the Code § 707(b) determination of the business-consumer percentage.[23]

U.S. Trustee continued his investigation to find a Code § 727(a) "bad act." He sought more documentation of more transactions, the production of specific invoices, and cancelled checks, Debtor-Wife's personal checkbook register, and receipts for or specific questions about multiple business transactions. All of these documents were produced. After Debtors had produced

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[21] Id. at para. 18.

[22] Ibid; see also Affidavit of Mrs. Santiago, supra at p. 3, para. 13; Affidavit of Mr. Santiago, supra at pp. 3-4, para. 17. Debtor-Husband's lack of involvement in preparation of both the Petition and Schedules and the Division Chart, as discussed infra, bears on his lack of intent to deceive. See discussion in text infra at p. 31 et seq.

[23] Affidavit of Bunch, supra at para. 19; Jt. Stips. at para. 80.

extensive documentation[24] and had given their explanations related mostly to Sanhatton business debts, by telephone calls or emails from Bankruptcy Counsel, U.S. Trustee claimed that Debtors had not disclosed all of their assets.[25]

On May 20, 2009, pursuant to Federal Rule of Bankruptcy Procedure 2004, U.S. Trustee deposed Debtors. Debtor-Husband shed little light on the various transactions–most of the questions asked him involved information known only by his wife. Debtor-Wife explained several discrepancies and corrected herself where she was in error. She was unable, however, to answer questions in three areas: (i) how the personally guaranteed Sanhatton rent was calculated (Bankruptcy Counsel had calculated it); (ii) where the $10,000 Bank of the Bluegrass proceeds went (Miller answered this question:[26] he had performed the corporate legal work necessary to allow the $10,000 loan proceeds to flow through to the company and back to Debtors by way of Debtor-Wife's stock subscription agreement);[27] and (iii) where the cash down payment on the farm came from (Miller and the closing lawyer, Damon R. Brown ("Brown")), knew the answer to this line of questioning).[28] Subsequent to the deposition, Bankruptcy Counsel obtained the farm transaction documentation, from Miller and Brown, and the Bank of the Bluegrass loan documentation, from

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[24] Review of Debtors' Exhibits, supra, adjusting for affidavits and pleadings included therein, shows that over 2,400 pages of documents were produced by Debtors to U.S. Trustee. U.S. Trustee also obtained additional documents via subpoenas to several banks. See Affidavit of Bunch, supra at pp. 13-14, paras. 37-38.

[25] Affidavit of Bunch, id. at para. 20; see also E-mail Threads in Debtors' Trial Brief, supra at Exhibit 5 therein.

[26] See Affidavit of Miller (Doc 133) at pp. 2-3, paras. 7-16; Transcript (Miller) supra at pp. 13-31.

[27] It is reasonable to expect Debtor-Wife, who signed only one piece of paper, not to be able to explain this complicated legal transaction; see Debtors' Trial Brief, supra at Exhibit 7).

[28] Affidavit of Bunch, supra at para. 23. These two transactions are discussed in deeper detail infra in text.

Miller, and sent all to U.S. Trustee, thus explaining and correcting inaccuracies regarding the farm closing proceeds and the loan closing proceeds.

In the deposition, Debtor-Husband testified that the farm was purchased as both an investment and for use by Sanhatton fighters on weekends. He testified that it had been used for weekend retreats for the fighters and that it had been rented out on weekends, but not often. Debtor-Wife testified that she had not spent a single night at the farm. Debtor-Husband testified that the Rolex watch was purchased and given as a signing bonus to Franklin Roberto (Bobby) Lashley ("Lashley"), a renowned martial arts fighter, as an incentive for him to sign a fight contract with Sanhatton.[29] Debtors had little, if any, tax knowledge about the corporate and personal tax returns prepared by their C.P.A. or information about their election of the Net Operating Loss ("NOL") carry-forward.[30]

It appears that from the investigation and depositions, U.S. Trustee was unable to find any undisclosed assets. He did, however, file his Complaint and Amended Complaint (Docs 1 & 2) on other grounds, and proceeded to trial.

II.

COUNTS

At trial U.S. Trustee argued specifically that Debtors should be denied a discharge because they (1) knowingly and fraudulently made false statements during their bankruptcy case, specifically with regard to the Division Chart listing of consumer debts as business debts; (2) did not keep

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[29] The purchase receipt with Lashley's name written on it had been produced to U.S. Trustee; see also Affidavit of Bunch, supra at para. 24. Lashley testified at the trial and verified that he received the gift from AFL as a signing bonus. Transcript (Lashley) pp. 9-10.

[30] Affidavit of Bunch, supra at para. 24.

adequate books and records to explain to U.S. Trustee the difference between the CPA's August 31, 2008, list of credit card charges to that on the Division Chart; (3) failed to list in the Statement of Financial Affairs ("SOFA") the gift of the Rolex watch to Lashley; and (4) lost the estate money for electing the NOL carry-forward on their 2008 tax returns instead of electing the NOL carry-back.

U.S. Trustee's proof included the affidavit of Todd Wright ("Wright"), C.P.A. (Doc 140), certain exhibits (Doc 138), Joint Stipulations (Doc 121), and cross-examination of Debtors and their witnesses at the trial. Wright's Affidavit included a recitation of the alleged inconsistencies in explanations of various business transactions and focused substantially on the farm debt. U.S. Trustee's Exhibits and the Joint Stipulations purported to document the inconsistencies of Debtors' oral explanations of the various business transactions.

In U.S. Trustee's Trial Brief (Doc 154) and arguments at trial, U.S. Trustee asserted that if Debtors made a statement under oath during the investigation and the statement turned out not to be completely accurate, then the statement was a false oath. U.S. Trustee regarded Debtors' later corrections or explanations as admissions of their lies and argued that the penalty was denial of discharge under Code § 727(a).

Debtors maintained that they provided more than adequate and reasonable explanations to the Code § 727 accusations; that their statements were based on their best information, knowledge and belief at the time the statements were made; that they never knew or had reason to believe that any of their statements were not true; that they never had any motive to lie; and that all the alleged events were not material to the case. As to any transaction where their initial explanations were shown to be incorrect or inaccurate, Debtors explained how and why they had so testified, and timely made corrections as soon as they knew of the error or found out why it was an error. Per

Bankruptcy Counsel, Debtor-Wife and he followed up to obtain information from others who had the answers, i.e., Miller, Brown, and Hatton. As a result of their explanations, Debtors maintained that U.S. Trustee ignored the prerequisites of Code § 727, which require intentionality, materiality, and egregiousness.

Debtors also argued that they (as individuals and as husband and wife), and he (as the managing member of Sanhatton), and Sanhatton were effectively one entity and regularly conducted transactions accordingly. This interwoven sphere, described by the Debtors as the "Santiago/Sanhatton Sphere," operated as one entity under the name of Sanhatton as a proprietorship and as their personal bank.

Of the various transactions occurring within the Santiago/Sanhatton Sphere, U.S. Trustee focused on multiple events and numerous transactions within those events, reduced to ten events because of the dismissals. U.S. Trustee at trial alleged that seven of the debts scheduled by Debtors as business debts were consumer in nature and that Debtors lied about the nature and classification of these debts (Counts 5, 8, 11, 12, 13, 14 and 16). In addition, U.S. Trustee argued that Debtors omitted the Rolex information from the SOFA (Count 21), which Debtors explained as a business gift and that the omission was an unintentional result caused by Bankruptcy Counsel's instruction to Debtor-Wife to include only personal gifts in the SOFA, and that Debtors failed to produce sufficient documentation to explain the C.P.A.'s August 31, 2008, accounts payable (Count 24), which Debtors claimed was both explained and was immaterial. U.S. Trustee argued that Debtors committed fraud by electing on their 2008 tax returns to carry the NOL forward (Count 26), which Debtors claimed was unintentional because they had no knowledge of the effect of the election on the estate and they relied upon the advice of a professional C.P.A. to elect the NOL carry-forward

to reduce their future tax obligations. Lastly, U.S. Trustee argued that the cumulative effect of these multiple events indicate violations of Code § 727(a) justifying denial of Debtors' discharges.

Count 5 (Bank of the Bluegrass). In Count 5 of his Complaint, U.S. Trustee alleged that Debtors gave a false oath when misstating how the proceeds from a $10,000 Bank of the Bluegrass loan were used. In the Division Chart, Debtor-Wife swore that approximately $7,316 of the $10,000 loan proceeds were deposited into the Sanhatton checking account and that the balance of the loan proceeds, $2,468, went into Debtors' personal account on February 19, 2008. The Sanhatton general ledger verified that a deposit of $7,316 was made in February 2008. Debtor-Wife made her statement based on a deposit ticket which was incorrectly dated by Debtor-Husband as February 19, 2008. The actual loan and bank deposit date, learned during her Rule 2004 deposition, was June 19, 2008, and Debtor-Husband's incorrect date on the deposit slip caused her to perpetuate the error in her explanation during her deposition.[31]

After Debtor-Wife discovered that her earlier explanation in the Division Chart was erroneous, she investigated and supplemented to U.S. Trustee the actual events involving the use of the Bank of the Bluegrass loan proceeds. Debtor-Wife's detailed explanation of this event was set forth in Debtors' Trial Brief, supra at Exhibit 8, pp. 1-4, supplemented by the Affidavit of Miller (Doc. No. 133) at Exhibit 7, pp. 2-4, paras. 7-16.[32]

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[31] See Debtor Exhibits, supra at pp. 2608-2609: the Deposit Slip for the $25,000, including the Miller & Wells escrow check for the Bank of the Bluegrass loan proceeds was incorrectly dated February 19, 2008, even though the Bank of the Bluegrass check was deposited on June 19, 2008.

[32] See also Affidavit of Mrs. Santiago, supra at pp. 7-9, paras. 36-54 and Affidavit of Mr. Santiago, supra at pp. 6-7, paras. 35-41. Debtors argued that there was little materiality to a $10,000 transaction in a $1.38 million bankruptcy. Debtors also argued that the $10,000 remained within the Santiago/Sanhatton sphere, so there was no dissipation of assets of the estate.

Although Debtor-Wife did make this statement in error, it was the justifiable result of her belief regarding her husband's incorrectly dated deposit slip compared to the date of the actual deposit. Debtor-Wife, upon learning of her mistake, investigated as to the use of the Bank's loan proceeds and, after explanation of the transaction from her personal-corporate attorney, Miller, reported by way of Bankruptcy Counsel to U.S. Trustee the correct and true disposition of these loan proceeds. [33]

Count 8 (Farm Property). In Count 8 of his Complaint, U.S. Trustee alleged that the farm located on Mackville Road in Harrodsburg, Kentucky was purchased by Debtors for their personal use and that categorization on the Division Chart of the farm's mortgage debt as a business debt was a false oath. With regard to categorization of the $168,000 farm mortgage obligation as business-related, Debtors testified that the farm property was purchased as a retreat for Sanhatton fighters, in order to keep the often violent martial arts fighters out of bars in downtown Lexington before a fight date, and in Debtors' minds was investment property.[34] The fact that the farm property did not provide a healthy revenue stream or was used only occasionally as a retreat for Sanhatton fighters does not change Debtors' mental intent in their acquisition and use of the property–namely, for Sanhatton's benefit and use for business purposes.

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[33] Miller used a Sanhatton stock subscription agreement to get the borrowed money into Sanhatton and then back to Debtor-Husband to avoid impairing the potential saleability of Sanhatton in June of 2008. See Affidavit of Miller, supra at pp. 2-3, paras. 7-16; Transcript (Miller) supra at pp. 13-31. It is reasonable to expect Debtor-Wife not to understand, and be able to understand and explain, the details of a loan, stock option agreement and escrow account distribution–a complicated legal transaction that took Miller eighteen pages of testimony at trial to explain. It is likewise understandable that Debtor-Wife was misled by the incorrectly dated deposit slip.

[34] Transcript (Mr. Santiago), supra at p. 216. Debtors and Bankruptcy Counsel testified that Bankruptcy Counsel made the classification decisions based upon his bankruptcy law experience.

U.S. Trustee countered Debtors' declared business purpose with evidence that their loan application was marked "secondary residence" on page 1[35] and that they did not deduct the mortgage payments as business expenses on their tax returns. Debtor-Husband testified at the trial that the banker knew that the purchase was for the AFL and as an investment and that it was the banker who filled out the form for execution at the closing, not Debtors.[36] Debtors' mental intent was illustrated by the fact that they did rent the farm out twice and that they did have fighters' retreats.[37]

U.S. Trustee offered no testimony that Debtors intended the farm to be a second home except to suggest that the loan application showed a check-marked box that the loan was for a "secondary residence." Debtor-Husband and Hatton testified that the farm was intended to be Sanhatton-related or an investment property.[38]

Debtor-Husband testified that they would not have purchased the farm without having the Sanhatton business. The notations on the loan application were representations made by the banker and were related to interest rates. Such notations were not conclusive of Debtors' mental intent.[39] Although U.S. Trustee argued that Debtors should have known that their farm mortgage payments were tax deductible because Debtors are sophisticated business people, the Court examined *sua sponte* witnesses at the trial and determined that Debtors had no prior experience

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[35] U.S. Trustee's Exhibits (Doc 138) Exhibit 9. The loan application was marked at p. 3 that Debtors intended the farm to be their "primary residence," contradictory to p. 1.

[36] Transcript (Mr. Santiago), supra at pp. 212-215.

[37] See Affidavit of Mr. Santiago, supra at pp.7-10, paras. 42-64 and Exhibits 10, 11 and 12 thereto; see also Affidavit of Hatton (Doc 134) at pp. 2-3, paras. 5-14; Affidavit of Miller, supra at p. 4, paras. 17-20; Affidavit of Mrs. Santiago, supra at pp. 10-12, paras. 55-81.

[38] Affidavit of Mr. Santiago, id. at p. 7, paras. 49-50; Transcript (Mr. Santiago) at pp. 211-216; Affidavit of Hatton, supra at pp. 2-3, paras. 5-14.

[39] Ibid.

or any knowledge of tax law.[40] The Court finds that the evidence shows the farm purchase was for business purposes.

Count 11 (Lexus Automobile). In Count 11, U.S. Trustee alleged that the Lexus automobile lease was a consumer debt and not a business debt, and that Debtors gave a false oath when they characterized the Lexus obligation as a Sanhatton business obligation on the Division Chart. The record is clear: the Lexus lease was in the name of Sanhatton, personally guaranteed by Debtor-Husband, and the vehicle was used almost exclusively for Sanhatton business purposes. Debtors had two other personal vehicles, a liened Hyundai and a 2002 Jaguar, that were driven for their personal use. Both Debtors testified that the Lexus was used only for business. U.S. Trustee contended that since the lease payments were not deducted on Sanhatton's tax return, the debt therefore was not business debt.[41]

U.S. Trustee produced no other evidence that the Lexus lease was a consumer obligation. Debtors did trade-in another personal automobile to lease the Lexus, but the trade-in of a personal vehicle does not *a priori* render the newly-leased vehicle a consumer obligation,[42] especially if the leased vehicle is used only for business purposes. The Court finds that the Lexus was used for business purposes and the lease obligation was a corporate obligation of Sanhatton and personally guaranteed by the Debtor-Husband.

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[40] Trial Transcript (Dye), supra at pp. 72-74; id. (Mrs. Santiago), supra at p. 84, lines 2-11 and at p. 154, lines 5-15 and p. 155, lines 9-24. Transcript (Mr. Santiago), supra at p. 197, lines 12-14: ". . . I sure don't understand everything on this tax return for a corporation. That's why I've got Mr. Dye." See also, id. at pp. 217-218, lines 21-25, lines 1-17.

[41] See discussion of Debtors' knowledge of tax law in text infra at 34-35; see fn. 70, infra. See also Affidavit of Mrs. Santiago, supra at pp. 12-14, paras. 82-94; Affidavit of Mr. Santiago, supra at pp. 10-11, paras. 65-75; Affidavit of Miller, supra at p. 5, paras. 23-24.

[42] The trade-in of a personally-owned vehicle to obtain a company-owned vehicle suggests that the "Santiago/Sanhatton sphere," wherein Debtors commingled personal and corporate debts, exists.

Count 12 (Discover Card). In Count 12 of his Complaint, U.S. Trustee alleged that Debtors gave a false oath by providing him with a copy of their November 2008 Discover Statement containing handwritten notations indicating that three transactions were AFL expenses when in fact the three transactions were consumer in nature.

The three transactions, totaling $215.25,[43] were among hundreds of transactions which Debtors documented to U.S. Trustee. A copy of the November Discover Card Statement was delivered to U.S. Trustee, attached as supporting documentation to the Division Chart. The Division Chart characterized $3,053.65 of the scheduled $5,909.41 Discover Card debt as consumer debts, thus the three notations were, at most, internal inconsistencies warranting some further albeit minimal inquiry. They are not material to administration of this chapter 7 case.

During her Rule 2004 deposition in 2009, Debtor-Wife testified (1) that the three notations were made in error by her in 2008 but were never included in the reimbursement request spreadsheet and (2) that the numbers in the Schedules and the Division Chart were correct, with only the notation on the face of the attached billing statement being incorrect.[44] Following her deposition, Debtor-Wife reviewed the documents and verified that the three mistakenly-marked transactions were not included as business debts on the expense report worksheets or on the Division Chart so the Division Chart numbers were in fact correct. Debtor-Wife testified that the notations on the credit card statements had been done in 2008 before the chapter 7 case was filed. The Court finds that Debtor-Wife had no intent to deceive U.S. Trustee with regard to these three, minor transactions, that any error was simply the result of an honest mistake and inadvertence, and that Debtor-Wife corrected

[43] Jt. Stips. at para. 130.

[44] Affidavit of Mrs. Santiago, supra at pp. 14-15, para. 99-104.

the error when asked about it.[45] The $215.25 error is not material to this case. U.S. Trustee put on no other proof that Debtor-Wife intended to defraud with regard to this Count.

Count 13 (Credit Card Liabilities). In Count 13, U.S. Trustee alleged a false oath regarding two sets of numbers of credit card business debts on two documents. He maintained that these two sets of figures, although created at two different points in time, created by two different individuals, and created to contain different financial information, constituted a false oath as to the amount shown by Debtors in the Division Chart.

In his affidavit (Doc 136), William Dye, the C.P.A., ("Dye") testified, supra at pp. 2-3, lines 12-15, that the numbers of the credit card payables contained in the February 2009 Division Chart and in his August 31, 2008, AP Schedule are in fact different but that this difference is because the Division Chart had credit card charges incurred after August 2008 included in it and his list did not. Thus, the two sets of numbers would not and could not be identical.[46]

Debtors' figures were devised when Debtor-Wife was working on the Division Chart with Bankruptcy Counsel, and he compiled the totals of credit card debts using credit card statements received after the December 1, 2008, filing date. This date was well after Dye received his set of figures for the debts in place as of August 31, 2009. The difference in the figures is attributed to Debtor-Wife and Bankruptcy Counsel having more up-to-date information. U.S. Trustee offered no proof that the Debtors fraudulently misrepresented their figures either to Dye or to U.S. Trustee. There was no proof of a false oath as to this event.

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[45] See Affidavit of Mrs. Santiago, supra at pp. 14-15, paras. 101-107; Affidavit of Mr. Santiago, supra at p. 11, paras. 76-81.

[46] Affidavit of Mrs. Santiago, supra at pp. 15-18, paras. 108-125; Affidavit of Dye (Doc. No. 136) supra at pp. 2-3, paras. 12-15; Affidavit of Mr. Santiago, supra at pp. 11-12, paras. 82-87. Debtor-Wife and Bankruptcy Counsel had credit card statements through October 2008 when they put together the Petition/Schedules in November 2008, and had credit card statements through January 2009 when they put together the Division Chart in February 2009.

Count 16 (Trade Accounts Payable). In Count 16 of his Complaint, U.S. Trustee alleged that Debtors gave a false oath in the Division Chart when they provided differing amounts owed with regard to two creditors on two documents. These allegations are similar to the allegations at issue in Count 13, except here they relate to two specific creditors (Miller and LDM), both determined at two different times. As set forth in the record herein and affidavits, the amounts related to the two different creditors differed on the two documents for two different reasons.[47]

One creditor (Miller of Miller & Wells, attorneys) performed additional legal work after August 31, 2008, creating a higher billing amount. Billings for this work would not have appeared on Dye's AP Schedule dated August 31, 2008, but the higher billing amount did appear in the Petition and Schedules prepared in November 2008 and on the Division Chart prepared in February 2009 by Debtor-Wife and Bankruptcy Counsel using the updated billing statement.

The other creditor (LDM Worldwide) agreed to settle its claim against Debtors and Sanhatton, and this lower settlement amount was reflected on Dye's AP Schedule. Debtors/Sanhatton, however, failed to pay the negotiated lower settlement amount, at which point LDM demanded full payment of the amount owed. Bankruptcy Counsel and Debtor-Wife used the full amount in Debtors' Schedules on December 1, 2008, and in the Division Chart of February 2009. This explanation was given to U.S. Trustee.[48] There is no proof of a false oath. Debtors have adequately explained the differences in the two sets of figures.

Count 21 (Rolex Watch). U.S. Trustee had alleged in Count 22 that Debtors gave a false oath in the Division Chart by stating that a specific credit card was used for business purchases when

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[47] See Affidavit of Mr. Santiago, supra at pp. 12-13.

[48] See Affidavit of Miller, supra at p. 2, paras. 5-6 and paras. 25-26; Affidavit of Mrs. Santiago, supra at pp.18-19, paras. 126-135; and Affidavit of Mr. Santiago, supra at pp. 12-13, paras. 88-100

it was for consumer purchases. The credit card transaction was the purchase of a Rolex watch for $9,540 from Surgener Jewelers.

Debtors' explanation was that the Rolex watch was purchased by Debtor-Husband using a personal credit card for a Sanhatton corporate gift to one of the AFL fighters, Lashley, and for which Debtors would obtain corporate reimbursement.[49] Their proof was that this kind of gift is typical in the world of extreme fighting to induce contract signings, that the Rolex watch was intended, when purchased, to be a corporate gift to Lashley, and that the watch was actually given to Lashley and never returned to Debtors.[50] Count 22 was dismissed by U.S. Trustee (Doc 119).

Count 21, which remained, alleged that Debtors intentionally omitted reference to this transaction in their SOFA. They did omit the reference, but explained the omission in their depositions and in Debtor-Wife's Affidavit: During preparation of the SOFA with Debtor-Wife, Bankruptcy Counsel kept receiving business answers from her to personal questions in the SOFA. Bankruptcy Counsel numerous times admonished Debtor-Wife to give personal answers. When asked if any personal gifts had been made within the last one year, he added, "personally, not corporate," and she answered "no," believing that the Rolex watch was a corporate or business-related gift.[51] Debtors continued to describe the cost of the Rolex watch as a business expense, one they were not required to list in the SOFA.[52] There is a valid explanation as to why the Rolex

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[49] Jt. Stips. at para. 145.

[50] This was verified by Lashley at the trial. Transcript (Lashley), supra at pp. 9-10.

[51] Jt. Stips. at para. 145.

[52] See Affidavit of Mrs. Santiago, supra at pp. 19-20, paras. 136-145; and Affidavit of Miller, supra at pp. 4-5, paras. 21-22; Affidavit of Mr. Santiago, supra at pp. 14-15, paras. 101-111.

reference was omitted from the SOFA, excusing Debtors from intentional and fraudulent wrong-doing under Code § 727(a) with regard to this Count.

Count 24 (Convenience Checks). In Count 24 of his Complaint, U.S. Trustee alleged that Debtors gave a false oath in their Division Chart by characterizing a credit card convenience check for $10,000 as a business obligation. According to Debtors, the convenience check was drawn on a credit card to compensate Debtor-Husband for a portion of his unpaid wages. U.S. Trustee claims that if these were wages, they should have been reported as such to their C.P.A., an IRS Form 1099 issued, and notation made in their 2008 tax return. He asserts that since none of these occurred, the money was not wages and Debtors made a false oath.

Debtors produced sufficient documentation to show there were unpaid earned wages: From March 17, 2008, through September 28, 2008, Debtor-Husband earned $94,791.62 in salary from Sanhatton. However, he received only $27,083.32. In addition, between June 18, 2008, and September 18, 2008, Debtors transferred a total of $36,897.71 from their personal checking account for Sanhatton expenses.[53] Therefore, according to Debtors, the $10,000 was a partial payment on unpaid wages. Dye prepared Debtors' and Sanhatton's tax returns and kept a general ledger based on expense reports and other documentation provided to him by Debtors or obtained by him from the internet.[54] Debtors, not having tax and accounting background, did not provide this payment information to their C.P.A. Consequently, Dye did not use, and did not know to use, this information in preparing Debtors' tax returns. His failure to have the information does not support U.S. Trustee's negative conclusion that Debtors' mental application of the money as wages was

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[53] Debtors' Trial Brief (Doc. No. 153), fn. 36 and Exhibit 18 pp. 2-4.

[54] Affidavit of Mrs. Santiago, supra at pp. 23-26, paras. 173-193; Affidavit of Mr. Santiago, supra at pp. 17-19, paras. 128-143; Transcript (Dye), supra at p. 74, lines 15-21.

false and was therefore a lie. U.S. Trustee has not shown that a false oath occurred with respect to the convenience check.

Count 26 (NOL Carry Forward). In Count 26, U.S. Trustee alleged that Debtors intended to "hinder, delay, or defraud" by electing to take an approximately $200,000 NOL carry-forward as opposed to electing to take a $200,000 NOL carry-back on their 2008 tax return.

Debtors made their election during preparation of their 2008 tax returns based on the recommendation of their C.P.A., Dye. As he testified in his Affidavit, supra at p. 3, and at the trial, Transcript at pp. 55-58, Dye offered Debtor-Husband two options: either carry the NOL backward, although the effect of doing so was unknown to Dye and would result in a forgiveness of debt and additional income tax the following year because of the bankruptcy, or carry the NOL forward to avoid the cancellation of indebtedness income related to the bankruptcy.[55]

Dye was unable to provide Debtors with an explanation of the effect of an NOL carry- back. Further, Dye appears to have misstated to Debtors the tax consequences of a bankruptcy discharge.[56] At trial Dye testified that he had conveyed to Debtor-Husband his bias of using the NOL forward.[57] In making the election, Debtor-Husband relied on Dye's information. Debtor-Wife thereafter signed the return without any conversation with Dye, relying only on Debtor-Husband's representation that

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[55] See Affidavit of Mr. Santiago, supra at pp. 19-20, paras. 144-152; Affidavit of Dye, supra at p. 3, para. 16, Transcript (Dye) at pp. 55-58. Affidavit of Mrs. Santiago, supra at p. 26, paras. 194-198.

[56] Transcript (Dye), supra at pp. 56-57 lines 24-25, 1-3; pp. 64-65. Federal tax law provides, in pertinent part, that "Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) if indebtedness of the taxpayer if – (A) the discharge occurs in a title 11 case." 26 U.S.C. § 108(a)(1). Federal tax law further provides that certain tax attributes, including net operating losses, may be reduced "one dollar for each dollar excluded by subsection (a)." 26 U.S.C. §108(b)(2)(A), (3)(A). Although Dye may have been incorrect in his conclusions relating to the NOL, there is no evidence that he intended to defraud the trustee or Debtors' creditors. This lack of intent on Dye's part suggests that in deciding to follow the advice of their C.P.A. , Debtors did not have an intent to defraud, unless superior tax knowledge can be imputed to them.

[57] Transcript (Dye), supra at p. 66.

Dye had prepared the returns and that they were correct. U.S. Trustee has failed to prove that Debtors' reliance on the advice of a professional was done with the intent to defraud their creditors or U.S. Trustee.[58]

III.

APPLICABLE LAW

In general, this case involves U.S. Trustee's assertions that in 2008 Debtors violated Code § 727(a) multiple times by lying, making false oaths, or perjuring themselves as to the facts surrounding their December 1, 2008, chapter 7 filing. The ultimate determination herein depends upon intentionality, materiality, egregiousness of the conduct, and Debtors' credibility. Review of the applicable law is necessary.

> [T]he legal effect of a bankruptcy discharge is grounded upon the public policy of freeing the honest, but unfortunate, debtor from the financial burdens of prepetition debts. *See e.g., Williams v. United States Fidelity & Guar., Co.*, 236 U.S. 549, 554-55, 35 S.Ct. 289, 59 L.Ed. 713 (1915); *Local Loan Co. v. Hunt*, 292 U.S. 234, 244, 54 S.Ct. 695, 78 L.Ed. 1230 (1934) . . . .
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> Significantly, the denial of a debtor's discharge is a harsh outcome; therefore, the provisions set forth in 11 U.S.C. § 727(a) are precisely drawn so as to encompass only those individual debtors who have not been honest and forthcoming about their financial affairs. *See, e.g., Buckeye Retirement Properties v. Tauber (In re Tauber)*, 349 B.R. 540, 545 (Bankr. N.D. Ind. 2006) ("The denial of a debtor's discharge is akin to financial capital punishment. It is reserved for the most egregious misconduct by a debtor."). Indeed, the denial of a general discharge can work a serious deprivation upon a debtor, and there are many circumstances where a debtor's acts and omissions may have been inadvertent or otherwise excusable. Thus, the provisions of § 727(a) are to be construed liberally in favor of granting debtors the fresh financial start contemplated by the Bankruptcy Code and the Supreme Court, and construed strictly against parties seeking to deny the granting of a debtor's discharge. *See, among others, Meyers v. Internal Revenue Service (In re Meyers)*, 196 F.3d 622, 624 (6th Cir. 1999) (quoting *Grogan v. Garner*, 498 U.S. 279, 286-87, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991)). As the party seeking the denial of the debtors' general discharges, the United States trustee, as plaintiff, bears

[58] Id. at pp. 72-74; see also Transcript (Mr. Santiago), supra at pp. 208-209.

> the burden of proving that the debtors are not entitled to discharges under § 727(a). *See* Fed. R. Bankr. P. 4005. The standard of proof for allegations under § 727(a) is by a preponderance of the evidence. *See Grogan*, 498 U.S. at 286-87, 11 S.Ct. 654.

Clippard v. Jarrett (In re Jarrett), 417 B.R. 896, 901 (Bankr. W.D. Tenn. 2009). Further, the standard of the Court's examination is the "totality of the circumstances" rule:

> When deciding whether to dismiss a case for lack of good faith, the court must examine the facts of that particular case and focus on a totality of the circumstances. *In re Stump*, 280 B.R. 208, 214 (Bankr. S.D. Ohio 2002); *In re Spagnolia*, 199 B.R. 362, 365 (Bankr. W.D. Ky. 1995). Dismissal should be reserved for only the most egregious cases. *Zick*, 931 F.2d at 1129; *Stump*, 280 B.R. at 214. . . .
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> As the Sixth Circuit advised in *Zick*, dismissal for bad faith is reserved for the most egregious cases. . . .
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> The denial of a debtor's discharge is a harsh outcome; therefore, the provisions set forth in 11 U.S.C. § 727(a) are precisely drawn so as to encompass only those individual debtors who have not been honest and forthcoming about their financial affairs. *See e.g., Buckeye Retirement Properties, v. Tauber (In re Tauber)*, 349 B.R. 540, 545 (Bankr. N.D. Ind. 2006) ("The denial of a debtor's discharge is akin to financial capital punishment. It is reserved for the most egregious misconduct by a debtor.").

1720 Entertainment LLC v. Palmer (In re Palmer), 419 B.R. 762, 768-70 (Bankr. M.D. Tenn. 2009) (quoting *Clippard v. Jarrett (In re Jarrett)*, 417 B.R. 896 (Bankr. W.D. Tenn. 2009)).

U.S. Trustee does not contend that Debtors concealed or hid an asset or that Debtors hid cash in a remote location, understated their income, overstated their expenses, omitted creditors or debts, committed an overt act of wrong-doing (excepting the Rolex or NOL Counts), or committed egregious acts. However, he asserts that the cumulative nature of the events proves his case, and justifies denial of discharge.

In reliance, U.S. Trustee cites *Philadelphia Inquirer v. Burnley (In re Burnley)*, 1999 Bankr. LEXIS 1164 (Bankr. E.D. Pa. 1999). The *Burnley* court, looking to the cumulative misstatements

of the debtor in determining that a denial of discharge was warranted, reviewed and analyzed each alleged misstatement separately to determine fraud.[59] The misstatements there, however, were significantly different from those in the present case. In *Burnley*, the debtor, *inter alia*, omitted from Schedule E nearly $10,000 in tax claims owed to the IRS; included secured debts on both a vehicle and a residence on which he was not liable; and intentionally understated his monthly net income on his statement of financial affairs, understating in some years by as much as 54%. Id. at *2-*5. Furthermore, the debtor in *Burnley* resisted "very minimal discovery requests" and responded to inquiry with evasiveness. Id. at *2, *11. By contrast, Debtors here repeatedly have stated that any "misstatement" on their part was the result of confusion, mistake, or advice of their Bankruptcy Counsel or their C.P.A. and that all such misstatements were timely corrected and documented with straightforward explanations.

The legal analysis in *Burnley* is sound: it requires the cumulative existence of both intentional falsehoods and materiality to warrant a Code § 727(a)(4) denial of discharge. Id. at *13. Viewed cumulatively, the errors in the *Burnley* petition, schedules and statement of financial affairs were egregious enough to justify denial of the debtor's discharge. Unlike Debtors here, the numbers in *Burnley* also showed that the debtor could have funded a Chapter 13 plan, which was material.[60] Id. at 18. Thus, considering materiality and egregiousness, the court reached its conclusion

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[59] The *Burnley* misstatements and any explanations given thereto were, "at best, so evasive as to establish a reckless indifference to the truth and, at worst, direct evidence of knowing, false statements concerning his financial condition… ." Id. at *11. The *Burnley* debtor offered no "exculpatory explanations." Id. at *10. This Court has followed *Burnley* to the extent that it has, supra in text "reviewed and analyzed each alleged misstatement one-at-a-time to determine fraud." Id. at *2 -*5.

[60] Debtors differ again from the debtor in *Burnley*: as noted in text, supra at p. 4, these Debtors would never be able to confirm a Chapter 13 plan with any substantial payback to their creditors.

regarding cumulative effect. By contrast, these Debtors' acts do not rise to the level of egregiousness necessary to sanction denial of their discharge.

Here, U.S. Trustee alleged that Debtors misrepresented numerous different categories of debts to achieve the greater business-consumer debt ratio,[61] and that the cumulative effect thereof equates to intent and egregiousness. On March 10, 2009, U.S. Trustee waived his right to prosecute Code § 707(b) violations, admitted by entry of the agreed order that a majority of Debtors' debts were in fact business debts as of the Petition Date, and knew then that Debtors' totals of business debts exceeded 50.0%.[62]

According to Bankruptcy Counsel, in the Division Chart, Debtor-Wife worked with him to refine the business-consumer division in order to satisfy U.S. Trustee's request to show that a portion of the credit card debts was business-related. Bankruptcy Counsel and Debtor-Wife concluded that a total of $368,999.33 reflected in the Schedules was for personal consumer debt and that $1,013,209.99 was for business debt and documented each category (correspondence, contracts, credit card statements, monthly spreadsheets). As a result, 73.3% of Debtors' total indebtedness was business in nature.

Code § 727(a)(4)(A) provides an exception to dischargeability as a result of the debtor knowingly and fraudulently making a false oath or account. In *Keeney v. Smith (In re Keeney)*, 227 F.3d. 679 (6th Cir. 2000), the Sixth Circuit Court of Appeals held that the U.S. Trustee must prove, by a preponderance of the evidence, five different factors in order to succeed in an objection to discharge under this subsection: The U.S. Trustee carries the burden of proving

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61 Debtors calculation in the Division Chart was that 73.3% of their debts were business-related.

62 Ibid.

> by a preponderance of the evidence that: 1) the debtor made a statement under oath; 2) the statement was false; 3) the debtor knew the statement was false; 4) the debtor made the statement with fraudulent intent; and 5) the statement related materially to the bankruptcy case.

Id. at 685. This heavy burden is in large part to protect debtors who make mistaken statements to the trustee. Not only is someone objecting to entry of a debtor's discharge required to prove that the statement was false as a material matter, he also must prove that the debtors knew the statement was false and that they made the false statement with fraudulent intent. Denial of discharge under § 727(a)(4)(a) requires actual intent to defraud a creditor or officer of the estate. "The false oath must have related to a material matter. . . . [T]he omission of property of trivial value or property not subject to the claims of creditors has been treated as immaterial." 6-727 *Collier on Bankr.*, ¶ 727.04 (15th ed.).

> A false oath or declaration may also be found in the schedules.
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> To find the requisite degree of fraudulent intent, the court must find the debtor knowingly intended to defraud the trustee, or engaged in such reckless behavior as to justify the finding of fraud. The trustee may prove the debtor's fraud by evidence of the debtor's awareness of the omitted asset and by showing that the debtor knew the failure to list the asset could seriously mislead the trustee . . . .

In re Yonikus, 974 F.2d 901, 905 (7th Cir. 1992) (citation omitted). Furthermore, when a debtor comes forward on his own accord with information that was previously omitted, there is a strong inference that there was no fraudulent intent in the omission. *Gullickson v. Brown (In re Brown)*, 108 F.3d 1290, 1295 (10th Cir. 1997). Debtors here have done this by their investigations, corrections, and transmission of the results to U.S. Trustee.

The fraudulent classification of certain debts as business debts to evade the Means Test is a material violation of Code § 707(b).

U.S. Trustee argued at trial that Debtors fraudulently classified consumer debts as business debts in order to overcome the Means Test restriction, thus fraudulently inducing U.S. Trustee to waive his Code § 707(b) objection to discharge. For this theory to be plausible, U.S. Trustee must prove that Debtors had less than a majority of business debts and fraudulently reclassified their consumer debts as business debts so they would reach a majority of business debts.

Here, Debtors and their Bankruptcy Counsel believed on December 1, 2008, that the Petition and Schedules contained more than 50% business debts and that such debts were in fact business-related debts. Debtor-Wife and Bankruptcy Counsel determined in November 2008, prior to the filing date, that Debtors had a majority of business debts. The Division Chart supplied to U.S. Trustee in February 2009, prepared to reflect the credit card division, showed that 73.3% of Debtors' obligations were business debts.

This Court has analyzed each alleged event of misrepresentation and finds that Debtors have provided overwhelming evidence that the Division Chart and the supporting documentation thereto are substantially accurate. Given the evidence in the record and the testimony at trial, including that of Debtors, U.S. Trustee has not sustained his burden of proof, a preponderance of the evidence, that Debtors acted with the intent to defraud. *See Keeney*, 227 F.3d at 683 (violation of Code § 727 "must be proven by a preponderance of the evidence.").

Objections to discharge are to be construed strictly against the objector and in favor of the debtor, with the objector having the burden of proof. *See Rosen v. Bezner*, 996 F.2d 1527, 1531 (3d Cir. 1993). Here, U.S. Trustee showed that Debtors made some misstatements when questioned concerning the details of certain transactions, but those misstatements and omissions were corrected, justified, and explained.

U.S. Trustee argued that all he is required to prove is that Debtors made false statements with a "reckless disregard" for the truth.

> A false statement or omission that is made by mistake or inadvertence is not sufficient grounds upon which to base the denial of a discharge, but a knowingly false statement or omission made by the Debtor with reckless indifference to the truth will suffice as grounds for the denial of a Chapter 7 general discharge.

Hamo v. Wilson (In re Hamo), 233 B.R. 718, 725 (B.A.P. 6th Cir. 1999) (citation omitted). While a showing of reckless disregard for the truth will satisfy the *intent* requirement set out in *Keeney*, 227 F.3d 679, U.S. Trustee was required to prove that the statement or omission was *knowingly* false and that it was material. Here, the proof suggests that the falsity of Debtors' statements was caused merely by mistake.

There was no indication that Debtors' mistaken statements were knowingly false, or that Debtors possessed a reckless disregard for the truth. Although some of the statements made by them later proved to be untrue due to error or mistake, at the time the statements were made, Debtors believed the statements to be true and correct. They later corrected their mistakes and explained why or how the mistakes were made. This is the essence of case law that exonerates these Debtors. U.S. Trustee pressed Debtors for details of multiple transactions. In their attempts to recall the transactions, involving many pages of documents and business records, Debtors became confused and at times failed to recall specific details surrounding some of the transactions, thereby making an error in their initial response, something a debtor reasonably might do. Debtors then promptly and timely corrected the errors, something an honest debtor will do.

Materiality to the administration of the case is also an element of proof that is required. Here U.S. Trustee did not prove materiality in the various events alleged to be violations of Code §

727(a). For example, the panel trustee, Ms. Johnson, was not called to testify that Debtors' action interfered with or affected her administration of the case, or that Debtors' actions or inactions prevented "discovery of assets or past transactions." *Bailey v. Bailey (In re Bailey)*, 53 B.R. 732, 735 (Bankr. W.D. Ky. 1985). There also was no showing that Debtors' actions or inactions caused a diminution in the value of the estate, that assets were unaccounted for, that fraudulent conveyance or preferential conveyances were omitted, or that Debtors engaged in dissipation of assets before the filing date. Further, there was no evidence that Debtors concealed assets, lied about the values of assets, or misstated their exemptions. Proof of any of the foregoing would satisfy materiality, but none were present. Based upon the totality of the evidence, the Court finds that U.S. Trustee failed to prove materiality with respect to all counts other than the Rolex or NOL counts, discussed in text infra. Ibid.

U.S. Trustee also failed to adduce a preponderance of evidence relating to intentionality or recklessness. U.S. Trustee's reliance on omissions made by Debtors cannot be equated to positive proof of intentionality or recklessness. The Court finds that Debtors satisfactorily explained the various transactions or events alleged by U.S. Trustee to be in violation of Code § 727(a). Debtor-Wife testified that she and Bankruptcy Counsel spent many hours attempting to explain the various debt obligations of Sanhatton.[63] Both Debtors satisfactorily explained the disposition of their assets and the assets of Sanhatton. The Court finds Debtors' explanations as to the material aspects of their acts and non-acts satisfactory and credible in light of all the testimony.

An unusual aspect of this case is the extent that Bankruptcy Counsel participated in the preparation of the Petition-Schedules, made the determinations of business-consumer debts,

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[63] Transcript (Mrs. Santiago) pp. 149-150.

supervised the collection and delivery of the requested documentation and offered his testimony in-chief at the trial.[64] Debtors relied on his determinations and advice throughout the case and argue that they could not have had the requisite intent to defraud because of their reliance on Bankruptcy Counsel's advice, determinations, and actions. Although advice of counsel is not an absolute defense to the intentionality required by Code § 727(a), intentionality may be rebutted depending on the extent of the participation and legal advice made by a qualified bankruptcy lawyer. Here, the Court, taking into consideration Bankruptcy Counsel's affidavit,[65] the testimony of the Debtors, and the documents produced that were based upon Bankruptcy Counsel's actions and determinations throughout the case, Debtors had no motive to deceive, and they lacked the required intentionality to justify the finding of a false oath.

U.S. Trustee's contention that Debtors' failure to list the Rolex watch requires denial of their discharges must also fail for lack of proof of intent and materiality. Even though the Rolex was not reported in their SOFA, Debtor-Husband believed it to be a corporate gift to Lashley. At trial Lashley testified that it was a corporate gift to him as an inducement to sign the Sanhatton fight contract.[66] Bankruptcy Counsel's Affidavit that he questioned Debtor-Wife about this gift is sufficient for the Court to find that her reliance on Bankruptcy Counsel's designation of "personal, not corporate"[67] negates any implication of intent to defraud. This Count fails for lack of evidence.

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[64] See Affidavit of Bunch, supra.

[65] Bankruptcy Counsel has 45 years of experience as a bankruptcy attorney and has appeared numerous times before this Court. He has a reputation of being professional and honest.

[66] Transcript (Lashley), supra at pp.7-8.

[67] See text supra at pp. 19-20.

Lastly, U.S. Trustee argued that Debtors' discharges should be denied due to their failure to elect an NOL carry-forward, in violation of **Code § 727(a)(2)**. This Section provides an exception to dischargeability for fraudulent transfer or concealment of property, requiring actual intent to defraud a creditor or officer of the estate. Absent an actual intent to defraud creditors, the debtor's discharge should not be denied. *Moreno v. Ashworth (In re Moreno)*, 892 F.2d 417, 419 (5th Cir. 1990). *See also*, *First Texas Sav. Ass'n, Inc. v. Reed (In re Reed*), 700 F.2d 986, 991 (5th Cir. 1983). Furthermore, "the statutory requirements for a discharge in bankruptcy are 'construed liberally in favor of the debtor' and 'the reasons for denying a discharge . . . must be real and substantial, not merely technical and conjectural.'" *Commerce Bank & Trust Co. v. Burgess (In re Burgess)*, 955 F.2d 134, 137 (1st Cir. 1992) (quoting *Dilworth v. Boothe*, 69 F.2d 621, 624 (5th Cir. 1934)). In addition, "the intent to defraud must be actual," and discharge should not be denied for constructive intent to defraud. *Village of San Jose v. McWilliams*, 284 F.3d 785, 790 (7th Cir. 2002).

Required here was proof that Debtors intended to defraud the estate when they made their NOL election to carry back. Miller and Dye testified that Debtors had no tax background, training, or experience. Debtors' testimony supported this conclusion.[68] U.S. Trustee has failed in his burden of proving fraudulent intent.

The evidence is that Dye discussed with Debtors the need to make the NOL election. When the option of an NOL carry-back or carry-forward was discussed, Dye advised Debtor-Husband that because of their bankruptcy, the effect of the carry-back was unknown but could create tax problems

[68] Transcript (Miller), supra at p. 33, lines 12-25; id. (Dye), supra at pp. 72-74, lines 18-25, 1-8; id. (Mrs. Santiago), supra at p. 84, lines 2-11 and p. 154, lines 5-15 and p. 155, lines 9-24; Transcript (Mr. Santiago), supra at p. 157, lines 16-25; p. 158, lines 1-25, p. 159, lines 1-10; see also fn. 40, supra.

for them. He indicated his bias to elect a NOL carry-forward instead.[69] The evidence at trial was credible. The Court concludes that Debtors had valid reasons to rely upon Dye's professional recommendation.[70] Their "good faith reliance on the accountant's advice," qualifies them for a reliance defense. *See U.S. v. Duncan*, 850 F.2d 1104, 1116 (6th Cir. 1988) (citing *U.S. v. Whyte*, 699 F.2d 375 (7th Cir. 1983), and *U.S. v. Cox*, 348 F.2d 294, 296 (6th Cir. 1965)).

Debtors' good faith reliance upon the professional advice of their C.P.A. negates any finding of intent to defraud or to deceive the trustee or estate, as required by Code § 727(a)(2). As articulated in *U.S. v. Duncan*, supra, required is "(1) full disclosure of all pertinent facts, and (2) good faith reliance on the accountant's advice[.]" Ibid (citation omitted). Even though Dye was mistaken as to the ultimate tax consequence of the election, his conclusion at the time was reasonable and not inappropriate. When requested by U.S. Trustee, Debtors shared their tax returns with him, indicating a lack of intent to conceal. U.S. Trustee failed to meet his burden of proof, by a preponderance of evidence, to prove that Debtors' intended to defraud or deceive when they made the NOL election. A debtor's discharge should not be denied simply because he or she does not understand the consequences of tax law. Here, intent is relevant, and fraudulent intent was not proven. Count 26 fails.

IV.

CONCLUSION

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[69] See Affidavit of Dye, supra at p. 3, para. 16; Transcript (Dye) at pp. 55-58.

[70] See Transcript (Mr. Santiago), supra at p. 209, lines 7-14: "I was way up here on the whole conversation because that's why I hired a CPA. Cause I don't know anything about corporate tax law." See also fn. 40 & 41, supra.

Upon careful review of the record and considering the totality of the facts and circumstances, the Court finds that denial of Debtors' discharges under Code § 727(a) is not warranted. First, Debtors produced satisfactory documents, affidavits and explanations of all the multiple and disparate events cited by U.S. Trustee as false oaths or violations of Code § 727(a). Second, all earlier errors in documentation or information made by Debtors were shown to have been predicated upon reasonable bases, and the Court concludes that the errors were made innocently or by mistake, and were later rectified and explained by Debtors. Third, Debtors' bankruptcy attorney made multiple legal judgment calls relating to numerous events, *i.e.*, the CTB-SBA's mortgage, the Lexus lease, the calculation of the rent damages, and the divisions of the debts into business debts–consumer debts in the Division Chart, upon which judgments Debtors relied. The reliance was reasonable, and precludes a finding of intentionality to defraud. Fourth, Debtors' testimony at trial was credible. The Court is convinced that Debtors had no motive to perjure themselves and thus that there was no proof of the statutorily-required intention to deceive or defraud. Fifth, there was interplay and overlapping of personal and corporate activities in this closely-held corporation. Sixth, Debtors cooperated in U.S. Trustee's investigation; there was not a pattern of evasion; and Debtors turned over all documentation requested by U.S. Trustee. Lastly, any errors by Debtors did not rise to the level of egregiousness required.

In summary, Debtors' production at the request of U.S. Trustee was extensive, and unprecedented in this Court for a Code § 727 action. Further, aside from Debtors' reasonable reliance on professionals, specifically their Bankruptcy Counsel and C.P.A., Debtors were credible. In addition, the Court finds that U.S. Trustee failed to carry his burden of proof by a preponderance of the evidence.

The Court finds in favor of Debtors, and the Complaint is DISMISSED.

Copies to:

Philip Hanrahan, Esq.
W. Thomas Bunch, Esq.

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The affixing of this Court's electronic seal below is proof this document has been signed by the Judge and electronically entered by the Clerk in the official record of this case.

Signed By:
Joseph M. Scott, Jr.
Bankruptcy Judge
Dated: Wednesday, September 01, 2010
(jms)
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