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**UNITED STATES BANKRUPTCY COURT  
IN AND FOR THE DISTRICT OF ARIZONA**

**In Re** )  
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**STEVEN and LORELEI HARTLEY,** )  
 )  
                  **Debtors.** )  
 )  
\_\_\_\_\_ )  
 )  
**MARTY CISTARO *et al,*** )  
 )  
                  **Plaintiffs,** )  
 )  
**v.** )  
 )  
**STEVEN and LORELEI HARTLEY,** )  
 )  
                  **Defendants.** )  
 )  
\_\_\_\_\_ )

**Chapter 7 Proceedings**  
  
**Case No. 08-BK-05012-CGC**  
  
**Adv. No. 08-00521-CGC**  
  
**UNDER ADVISEMENT  
DECISION RE  
NONDISCHARGEABILITY**

**I. Introduction & Background**

Debtors operated New Millennium Security, as a sole proprietorship, until early 2008, providing security guards for construction projects. From late 2007 into early 2008, a downturn in business and unpaid invoices left New Millennium unable to pay its bills. Faced with an increasing debt load due to their failing business, the Debtors filed for bankruptcy on May 1, 2008.

Several employees claim that they are unpaid creditors because New Millenium did not pay their wages, properly remit withheld taxes, or both. On July 31, 2008, Daniel Hardy and Martin Cistaro filed an adversary proceeding on behalf of themselves, Nick Houston, Mary Chavez, Ed Bradford, Sytho Paul, Bob McCollum, Brent Johnson, Tarl Speakman and Theresa Smith asking the Court to find these debts nondischargeable. The Court advised the non filing

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1 parties that they must file a complaint on their own behalf. Marty Cistaro [Dkt # 12], Daniel  
2 Hardy [Dkt #13], Ed Bradford [Dkt #14], Nicholas Houston [Dkt #18], and Mary Chavez [Claim  
3 Register 17-1] each filed a “Response” as directed by the Court. The claims of those initial  
4 plaintiffs who did not file a complaint on their own behalf were dismissed. After a series of  
5 pretrial hearings, the Court held a trial on dischargeability on December 17, 2008.<sup>1</sup>

6 **II. Facts**

7 Cistaro claims \$4,968.66 in unpaid overtime and underpayments below his agreed  
8 hourly wage for 2006 and 2007. On January 16, 2008, the East Mesa Justice Court entered  
9 default judgment in favor of Cistaro for \$4,294.41 with interest at 10%. On April 28, 2008, the  
10 Maricopa County Superior Court issued a writ of general execution against Steven Hartley in  
11 favor of Cistaro. Mr. Cistaro further argues that the unpaid wages should have been taxed and  
12 were not.

13 Hardy claims unpaid wages of \$15,568 for 2006 and 2007 for time worked but not paid.  
14 Invoking A.R.S. §23-355, Hardy seeks to treble his damages to a total of \$46,242. According to  
15 Hardy’s 1099 for 2007, no taxes were withheld; but according to the “Recap of Taxes Owed for  
16 Guards on Withholding 2007” prepared by the Debtors (“Recap”)<sup>2</sup>, New Millennium withheld

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20 <sup>1</sup>The Court directed the plaintiffs to advise court staff when all post-hearing matters were  
21 submitted. None of the plaintiffs did so; this has resulted in an unfortunate delay in resolving this  
22 matter.

23 <sup>2</sup>The Recap shows:

<u>Employee</u>	<u>Amount</u>	<u>Federal</u>	<u>State</u>	<u>Social Security</u>	<u>Medicare</u>
	<u>Held</u>				
Ed Bradford	\$ 2,802.90	\$1,104.12	\$116.19	\$ 638.11	\$147.97
Mary Chavez	\$ 313.00	\$ 170.39	\$ 18.95	\$ 100.38	\$ 23.28
Danny Hardy	\$ 2,236.10	\$1,234.86	\$137.17	\$ 71.42	\$162.65
Nick Houston	All taxes withheld were reimbursed to Nick				

1 total taxes of \$2,236.10 on Hardy's account.<sup>3</sup>

2 Nick Houston claims that New Millennium did not report \$588 in taxes withheld. He  
3 provides a document titled "Houston-Recap- Payroll Owed" prepared by New Millennium that  
4 shows \$588.50 withheld for taxes and his 1099 from 2007 that shows no taxes withheld.  
5 According to the Recap, New Millennium returned all taxes withheld to Houston.

6 Chavez claims unpaid wages of \$551.25. Her claim is based on a Findings of Fact and  
7 Determination and Directive of Payment issued by the Industrial Commission of Arizona.  
8 ("Findings of Fact"). According to the Findings of Fact, Chavez is owed \$551.25 in unpaid  
9 wages for time worked in 2007. The Debtor claims that Chavez was paid by certified checks.  
10 However, according to the Findings of Fact the certified checks did not cover the entire unpaid  
11 wages, but instead replaced checks that were returned for insufficient funds. The Recap show  
12 that New Millennium withheld \$313 in taxes on Chavez's account.

13 Bradford claims total gross wages of \$33,794.86; wages received of \$19,865.47; leaving  
14 wages owed of \$13,929.39. Bradford claims the unpaid wages resulted from being paid \$9 per  
15 hour instead of the agreed to \$10 per hour. Bradford also claims that the Debtors under reported  
16 the taxes withheld by \$443.46. According to the Recap, New Millennium withheld \$2,802.90 in  
17 taxes. However, Bradford claims in a spreadsheet he prepared that New Millennium withheld  
18 \$1,222.46 in Federal taxes. Finally, a computer printout of his Account Transcript from the IRS  
19 shows \$779 withheld.

20 The Debtors contest most of the wage claims. Hartley testified that most of the former  
21 employees claim a higher hourly salary than what was agreed upon. For instance, Bradford  
22 claims a wage of \$10 per hour. However, Hartley claims that the wage was \$8 per hour, as  
23 provided in the employee handbook. According to Hartley, New Millennium never agreed to a  
24 \$10 per hour rate.

25 Barbara Baker, bookkeeper for New Millennium, acknowledged in her testimony that

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27 <sup>3</sup>The columns for each category of taxes withheld do not tie with the totals given under the  
28 heading "Amount Held." However, as these are the best records produced by Debtors, they will be  
responsible for the higher amounts

1 New Millennium's wages were at times late due to cash flow issues. Because of this, some  
2 employees have not been paid their full wages. She further testifies that the employees were  
3 apprised of the situation and New Millennium did its best to pay their wages.

4 Laying much of the blame on their payroll service provider Paychex, Baker concedes that  
5 New Millennium did not originally report or remit all withheld taxes to the IRS. Since the  
6 original reports were filed, Baker claims that New Millennium has amended its reports to the  
7 IRS to show the withheld taxes, but has not paid all of what has been withheld. In support of her  
8 testimony, the Debtors present amended Form 941s filed with the IRS. Bradford acknowledges  
9 that the IRS may not yet show the amended reports. She blames the lack of updates on a backlog  
10 with the IRS. Further, Baker testified that the W-2s have not been issued, so no dollar figures  
11 have been credited to individual employees.

### 12 **III. Analysis**

13 Pro se litigants are held to the same legal standards as attorneys. *In re Stober*, 193 B.R.  
14 5, 9 (Bankr. D. Ariz. 1996) (stating “[l]aymen who insist on representing themselves are held to  
15 the same standards as attorneys”); *see also Jacobsen v. Filler*, 790 F.2d 1362 (9th Cir. 1986);  
16 *United States v. Pinkey*, 548 F.2d 305, 311 (10th Cir. 1977) (“He who proceeds pro se with full  
17 knowledge and understanding of the risks does so with no greater rights than a litigant  
18 represented by a lawyer, and the trial court is under no obligation to become an ‘advocate’ for or  
19 to assist and guide the pro se layman through the trial thicket”). Here, no party is represented by  
20 an attorney. Nevertheless, all sides will be held to the same legal standards as if they were  
21 represented by counsel.

22 The issue in this case is not whether wages were not paid, or whether taxes were withheld  
23 and not remitted, but rather whether these failures, if proven, gives rise either to a non-  
24 dischargeable claim or grounds for denying the debtor's discharge in total. It is an unfortunate  
25 fact of bankruptcy cases that most debts may not be collected by a creditor after the case is  
26 commenced and are ultimately within the scope of the debtor's discharge. Debts that are outside  
27 the scope of the discharge are carefully delineated in Section 523 of the Bankruptcy Code.  
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1 Likewise, grounds for denying a discharge to a debtor are limited and specifically spelled out in  
2 Section 727.

3 The plaintiffs ask for relief under Sections 523(a)(19)(B)(1)<sup>4</sup>, 523(a)(1)(C)<sup>5</sup> and 727(a)(3)  
4 in the original complaint. After a review of the claims, the Court determines that the sections  
5 cited are inapplicable to these claims; rather, the plaintiffs' claims are properly based upon  
6 §523(a)(6) in conjunction with their unpaid wage claims, §523(a)(4) for their unreported taxes  
7 claim, and §727(a)(3) for both claims.

8 *a. Wage Claims*

9 The unpaid wages claims are breach of contract claims. Damages arising out of a breach  
10 of contract alone are normally discharged. To "be excepted from discharge under § 523(a)(6), a  
11 breach of contract must be accompanied by some form of 'tortious conduct' that gives rise to  
12 'willful and malicious injury.'" *In re Jercich*, 238 F.3d 1202, 1206 (9th Cir. 2000). To prevail  
13 under §523(a)(6), the plaintiffs must show that the nonpayment of wages was willful and  
14 malicious. They have not.

15 "[T]he willful injury requirement of § 523(a)(6) is met when it is shown either that the  
16 debtor had a subjective motive to inflict the injury or that the debtor believed that injury was  
17 substantially certain to occur as a result of his conduct." *Id.* at 1208. In *Jercich*, the Ninth  
18 Circuit ruled that the non payment of wages was a tort under California law and that it was  
19 willful and malicious because the debtor knew he owed the wages and had the clear ability to  
20 pay the wages, yet chose not to pay and instead used the money for the debtors own personal  
21 benefit. *Id.* at 1208, 1209.

22 Here, the facts are different. Hartley and his bookkeeper testified credibly regarding the  
23 payment of wages. First, they genuinely believe that they paid the plaintiffs the promised hourly  
24 wage under the employee handbook. The plaintiffs genuinely believe that they were entitled to a  
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26 <sup>4</sup> A claim under Subsection (a)(19) involves a violation of securities law.

27 <sup>5</sup> A claim under Subsection (a)(1) lies with the taxing authority. Nothing in this decision should  
28 be read to discharge the Debtors' liability to any taxing authority.

1 higher wage. The Court does not need to resolve which party is correct. Instead, to determine  
2 dischargeability, the Court must determine if the Debtors *intended* to underpay their employees.  
3 Here, the Court finds that Hartley did not intend to under pay the employees. Further, the  
4 bookkeeper testified that when they did run into cash flow issues and were struggling to pay all  
5 of New Millennium’s bills, they were candid with their employees regarding the late payment of  
6 wages. Unlike the debtor in *Jercich*, the Debtors here could not afford to pay the wages as they  
7 became due. The Court determines that the Debtor intended to pay their employees wages in  
8 full, but simply could not. The injury suffered by the employees was neither willful nor  
9 malicious. As such, the Employees’ claims for unpaid wages are dischargeable and therefore  
10 may not be collected post-discharge.

11 *b. Taxes.*

12 Employees have alleged defalcation while acting as a fiduciary. Under §523(a)(4), “[a]  
13 discharge under section 727, 1141, 1228(a), 1228(b), or 1328(b) of this title does not discharge  
14 an individual debtor from any debt . . . for fraud or defalcation while acting in a fiduciary  
15 capacity, embezzlement, or larceny.” To prevail, the plaintiffs must show: 1) that the new  
16 Millennium was a fiduciary; and 2) it engaged in defalcation.

17 “Whether a debtor is a fiduciary within the meaning of § 523(a)(4) is a question of  
18 federal law and is narrowly interpreted . . . ‘[t]he trust giving rise to the fiduciary relationship  
19 must be imposed prior to any wrongdoing; the debtor must have been a ‘trustee’ before the  
20 wrongdoing and without reference to it. These requirements eliminate constructive, resulting or  
21 implied trusts.’ ” *In re Kallmeyer*, 242 B.R. 492, 495 (9th Cir. BAP 1999) (quoting *Ragsdale v*  
22 *Haller*, 780 F.2d 794, 796 (9th Cir. 1986). “‘Withholding taxes’ are not simply a debt, but rather  
23 a part of wages of an employee, held by the employer in trust for the Government.” 47C C.J.S.  
24 Internal Revenue Service § 745 (2009). In this matter, once the taxes were withheld, the Debtors  
25 became fiduciaries because they held the taxes in trust for the employees.

26 Did the Debtors engage in defalcation? “Federal law defines what constitutes a  
27 defalcation: it is a misappropriation of trust funds or money held in any fiduciary capacity; [and  
28 the] failure to properly account for such funds.” *In re Niles*, 106 F.3d 1456, 1460 (9th Cir. 1997)

1 (internal quotation omitted). The Debtors admittedly withheld the money, but did not timely  
2 remit to the IRS. This is a misappropriation of trust funds held in a fiduciary capacity.  
3 However, a failure to remit to the IRS alone does not constitute defalcation against the  
4 employees. The Debtors must have failed to properly account for such funds.

5 “Where the employer has collected the tax but failed to pay it over to the United States,  
6 the employee is credited with payment, since the amount was deducted from his wages by the  
7 employer.” *Bloom v. U.S.*, 272 F.2d 215, 220 (9th Cir. 1960). *See also* 47C C.J.S. Internal  
8 Revenue Service § 745 (2009) (“An employee, on his tax return, is credited with the amount of  
9 tax withheld from his wages; even where the employer has failed to pay over the tax collected to  
10 the government.”). If the Debtors had reported but not paid the withholding amounts to the IRS  
11 the employees would have been credited with the withholding on their tax documents. Because  
12 taxes withheld were not reported, the employees cannot prove to the IRS that they paid their  
13 taxes. Thus, the employees incurred a greater tax liability. By not reporting taxes withheld to the  
14 IRS, the Debtors defalcated under §523(a)(4).

15 Once the plaintiffs established defalcation, the Debtors must properly account for the  
16 funds. *Niles* at 1462. Here, the Debtors have not met this burden. The Debtors provide  
17 amended tax returns to show the proper *total* withholding. However, the documents submitted to  
18 the Court do not show that the Debtors have amended their reports as to the *individual*  
19 employees. There is no evidence that the IRS has credited each individual employee with the  
20 taxes collected by New Millennium on their behalf.

21 *c. Records*

22 Under 11 U.S.C. §727(a)(3) the Court shall grant a discharge unless:

23 the debtor has concealed, destroyed, mutilated, falsified, or failed to keep or  
24 preserve any recorded information, including books, documents, records, and  
25 papers, from which the debtor's financial condition or business transactions might  
be ascertained, unless such act or failure to act was justified under all of the  
circumstances of the case.

26 However, “[t]he statute does not require absolute completeness in making or keeping records.”  
27 *In re Caneva*, 550 F.3d 755, 761 (9<sup>th</sup> Cir. 2008). Further, to prevail the employees must show,  
28 “(1) that the debtor failed to maintain and preserve adequate records, and (2) that such failure

1 makes it impossible to ascertain the debtor's financial condition and material business  
2 transactions.” *Id.* (internal citations omitted). Here, the Debtors have disclosed sufficient  
3 business records for the Court to determine their financial condition and business transactions.  
4 The debtors have disclosed payroll records, amended returns to the IRS and the Recap. Under  
5 the circumstances of this case, the Debtors maintained adequate records allowing the Court to  
6 ascertain the Debtors’ financial condition. A denial of discharge under §727(a)(3) is  
7 unwarranted.

#### 8 **IV. Conclusion**

9 Based on the foregoing, the Court finds: 1) that debts for unpaid wages are dischargeable;  
10 and 2) taxes withheld, of:

- 11 ● Ed Bradford \$2,802.00
- 12 ● Mary Chavez \$313.00
- 13 ● Danny Hardy \$2,236.20
- 14 ● Nick Houston \$588.50

15 are nondischargeable.

16 Cistaro claims that taxes should have been withheld on amounts that he wasn’t paid.  
17 Because he did not receive the payments, no taxes are due and therefore no withheld funds have  
18 been improperly retained by the Debtors. For this reason, Cistaro is not entitled to a judgment of  
19 nondischargeability.

20 Debtors are ordered to either: 1) report taxes withheld to the proper taxing authority or  
21 2) refund the amounts withheld to the employees within 30 days of this decision. The Debtors  
22 shall file proof that the taxes are reported or refunded with the Court within 45 days of this order.  
23 If the Debtors fail to file proof that the taxes are reported or refunded the amounts above will not  
24 be discharged and may be collected by the plaintiffs through usual court procedures  
25 notwithstanding the Debtor’s discharge.

26  
27 DATED: September 29, 2009  
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Charles G. Case  
UNITED STATES BANKRUPTCY JUDGE

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**COPY** of the foregoing mailed by the BNC and/or sent by auto-generated mail to:

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