IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

In re:	Chapter 7
Bake-Line Group, LLC, *et al.*,	Case No. 04-10104 (CSS)
Debtors.	

FINDINGS OF FACT AND CONCLUSIONS OF LAW

This matter comes before the Court following an evidentiary hearing conducted on January 15, 2019. The matter arises from the motion of the current chapter 7 trustee, George L. Miller ("Trustee Miller"), to disgorge fees paid to the former trustee, Montague Claybrook, over 14 years ago. Trustee Miller alleges that Mr. Claybrook's negligent handling of the Debtor's tax obligations in 2006 caused certain Internal Revenue Service ("IRS") penalty and interest assessments against the Debtor's estate. Whether Mr. Claybrook did or did not mishandle the Debtor's tax obligations in 2006 is ultimately less consequential, however, than the question of whether the IRS assessments were accurate. Having considered the legal arguments and the evidence presented, the Court concludes that Mr. Miller has not satisfied his burden of proving by a preponderance of the evidence that the IRS assessments were accurate. Accordingly, Mr. Claybrook will not be held liable for such assessments against the Debtors' estate, and Trustee Miller's motion will be denied.

BACKGROUND AND PROCEDURAL HISTORY

1. On January 12, 2004 (the "Petition Date"), Bake-Line Group, LLC and its affiliates (the "Debtors") commenced voluntary petitions for relief under chapter 7 of the Bankruptcy Code.[1]

2. On the Petition Date, Montague Claybrook was appointed as the chapter 7 trustee for the Debtors' bankruptcy estate (the "Estate").

3. On July 18, 2013, Mr. Claybrook resigned from his appointment in all pending bankruptcy proceedings, including the Debtors' cases.

4. On July 26, 2013, Trustee Miller was appointed as successor chapter 7 trustee of the Estate.

5. On May 8, 2018, Trustee Miller filed the *Motion of George L. Miller, Successor Chapter 7 Trustee, for Entry of an Order Disgorging Certain Compensation Paid to the Former Chapter 7 Trustee, Montague S. Claybrook* (the "Disgorgement Motion").[2] By this Disgorgement Motion, Trustee Miller seeks entry of an order directing disgorgement of compensation paid to Mr. Claybrook from his time as the chapter 7 trustee, with such disgorgement to equal no less than $109,329.50 (plus accruing interest), corresponding with the total amount of certain tax obligations assessed by the IRS against the Debtor (further defined herein as the "IRS Tax Obligation"), which Trustee Miller asserts arises from Mr. Claybrook's negligence in handling certain of the Debtor's IRS tax filings during his time as trustee.

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[1] D.I. 1.

[2] D.I. 898.

6. On October 17, 2018, Mr. Claybrook filed the *Objection of Montague S. Claybrook to the Motion of George L. Miller, Successor chapter 7 Trustee, for the Entry of an Order Disgorging Certain Compensation Paid to the Former Chapter 7 trustee, Montague S. Claybrook* ("Objection").[3] Mr. Claybrook objects to the Disgorgement Motion on the following grounds: (1) the Trustee cannot establish by a preponderance of the evidence that the IRS Tax Obligation resulted from Mr. Claybrook's alleged negligence because the evidence on which Trustee Miller relies is demonstrably flawed and inaccurate; (2) the IRS's application of certain refunds to the IRS Tax Obligation was an unauthorized postpetition setoff because (i) most of the penalties assessed by the IRS as part of the IRS Tax Obligation are general unsecured claims that should be subordinated to the claims of other holders of allowed claims and (ii) most of the interest assessed should be disallowed; (3) Trustee Miller's request for disgorgement is barred by the doctrine of laches because (i) Trustee Miller did not file the Disgorgement Motion until almost 5 years after he was appointed and more than two years after the date that he absolutely had notice that the IRS had applied certain of the Debtor's refunds to the IRS Tax Obligation and (ii) Trustee Miller has not pursued the IRS for its unauthorized setoff nor objected to its unpaid penalty claim; and (4) even if the IRS Tax Obligation resulted from Mr. Claybrook's actions, the Court should deny the Disgorgement Motion because Mr. Claybrook was entitled to additional compensation for his service as chapter 7 Trustee for the Debtor in excess of the amount of the IRS Tax Obligation.

[3] D.I. 926.

7. On December 28, 2018, Trustee Miller filed the *Successor Chapter 7 Trustee's Reply to the Objection of Montague S. Claybrook to the Motion of George L. Miller, Successor Chapter 7 Trustee, for Entry of an Order Disgorging Certain Compensation Paid to the Former Chapter 7 Trustee, Montague S. Claybrook*.[4]

8. On January 15, 2019, the Court held an evidentiary hearing regarding the Disgorgement Motion.[5]

FINDINGS OF FACT

9. Prior to his resignation, Mr. Claybrook administered the assets of the Debtor as the chapter 7 trustee. Among other things, Mr. Claybrook was tasked with: (1) collecting property of the Debtor; (2) closing the Debtor as expeditiously as is compatible with the best interests of parties in interests; (3) being accountable for all property received; (4) furnishing information concerning the Debtor and its administration if requested by a party in interest; and (5) abiding by the Handbook for Chapter 7 Trustees issued by the Department of Justice, Executive Office for United States Trustees, which includes the duty to file appropriate tax returns and pay tax liabilities on behalf of the Debtor.

10. On November 18, 2005, the Court entered an order (the "Settlement Order")[6] approving a stipulation (the "WARN Act Settlement Stipulation") settling an

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[4] D.I. 929.

[5] D.I. 934. References to "Ex." are to the Hearing Exhibits entered into evidence during the hearing held on January 15, 2019. References to "Hr'g Tr." are to the January 15, 2019, hearing transcript filed on January 22, 2019 (D.I. 936).

[6] D.I. 465.

adversary proceeding filed by certain WARN Act claimants (the "WARN Plaintiffs" or "Plaintiffs"). The WARN Act Settlement Stipulation granted the Plaintiffs an allowed priority claim in the amount of $590,000, to be paid as follows:[7]

a. Within 30 days of the Court's entry of a final non-appealable order approving this Stipulation, the Trustee shall: (a) issue in each Plaintiff's name a check in the amount of $1,136.36 less $378.78 for Plaintiffs Counsel's fees and less appropriate taxes and withholdings; (b) issue to Plaintiffs' Counsel a check for $66,665.92; and

b. Within 30 days of the date on which the total amount of funds that the Trustee has received from settlement of or judgment in adversary actions brought by the Trustee in these bankruptcy cases exceeds $2.5 million, the Trustee shall (a) issue a check in the name of each Plaintiff in the amount of $2,215.91 less $738.64 in attorney's fees and less appropriate taxes and withholdings; and (b) issue to Plaintiffs' Counsel a check in the amount of $130,000.

11. On December 8, 2005, Mr. Claybrook issued two checks to each Plaintiff for the amounts required to be paid in paragraphs 1(i) and 1(ii) of the WARN ACT Settlement Stipulation. The total amount of these checks was $261,515.78.3.[8]

12. On December 8, 2005, Mr. Claybrook also issued the following checks to the IRS in connection with the WARN Act Settlement Stipulation:

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[7] *See* Ex. X (WARN Act Settlement Stipulation §1).

[8] *See* Ex. C (Trustee's Final Report) at 40-92.

a. a check to the IRS for Federal Withholding in the amount of $78,666.72 (check no. 227);

b. a check to the IRS for the WARN Plaintiffs' portion of FICA in the amount of $24,386.56 (check no. 228); and

c. a check to the IRS for the WARN Plaintiffs' portion of Medicare in the amount of $5,702.40 (check no. 229).

The total amount of these checks issued to the IRS on December 8, 2005 was $108,755.68.[9]

13. On January 9, 2006, based on a motion filed by Mr. Claybrook, the Court awarded him interim compensation in the amount of $232,500.90.[10]

14. On March 1, 2006, Mr. Claybrook issued a check to the IRS for the Debtor's portion of Medicare in the amount of $5,702.40 (check no. 589).[11]

15. On March 8, 2006, Mr. Claybrook issued a check to the IRS for the Debtor's portion of FICA in the amount of $24,386.56 (check no. 558).[12]

16. All five checks issued to the IRS relating to the WARN Act Settlement (check nos. 227, 228, 229, 558, and 589), totaling $138,844.64, cleared the Debtor's bank account on March 21, 2006 (collectively, the "2006 Claybrook Payments").[13]

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[9] Ex. A at 1.

[10] D.I. 505.

[11] Ex. A at 1.

[12] *Id*.

[13] Ex. A & B.

17. The Debtor's IRS Form 940 for 2005 was due no later than January 31, 2006, but the IRS did not receive it until March 30, 2006.[14]

18. The Debtor's IRS Form 941 for the fourth quarter of 2005 was due no later than January 31, 2006, but the IRS did not receive it until March 10, 2006.[15]

19. Mr. Claybrook testified that the reason he did not timely file Forms 940 and 941 is because he was waiting to pay approximately twenty of the WARN Plaintiffs in accordance with the WARN Act Stipulation, which required determining their appropriate addresses. The amount actually paid to the WARN Plaintiffs would ultimately determine the amounts to be properly reported on Forms 940 and 941. After making several attempts, using several databases, the checks paid to a number of the Plaintiffs were returned undeliverable. Mr. Claybrook ultimately was able to obtain the Plaintiffs' information from their class counsel by March of 2006, after the due date for the Forms 940 and 941, at which point he filed the relevant Forms. Mr. Claybrook did not seek an extension or otherwise contact the IRS regarding the late filing.[16]

20. Form W-2s were due to the Social Security Administration by February 28, 2006, in connection with the issuance of payments made under the WARN Act Settlement Stipulation.[17] Mr. Claybrook never provided these Form W-2s because he was not able to comply with the Social Security Administration's instructions on sending

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[14] Hr'g Tr. 31:13-15; Ex. G.

[15] Hr'g Tr. 26:13-16, 84:8-18; Ex. E at 2.

[16] Hr'g Tr. 77:11 – 78:24.

[17] Hr'g Tr. 81:2-5.

them. Sending these Forms in compliance with the Social Security Administration's instructions required a software that Mr. Claybrook did not have. Mr. Claybrook sought to use the software of other businesses, but no one he contacted was willing to provide their software to him. Ultimately, Mr. Claybrook made a business judgment to not make any further efforts to send the Form W-2's to the Social Security Administration.[18] Mr. Claybrook never attempted to contact the Social Security Administration regarding his inability to comply.

21. According to the IRS Account Transcripts for Forms 940, 941, and Civil Penalty (W-2), the IRS assessed the following penalties and interest against the Debtor (collectively, the "IRS Tax Obligation"):

a. 940 Account Transcript. $716.23 for filing after the due date; $795.81 Federal tax deposit penalty; and $79.58 for late payment of tax. Penalty total: $1,591.62. Interest total: $1,014.84.[19]

b. 941 Account Transcript. $12,496.21 for filing after due date; $13,884.67 Federal tax deposit penalty; $1,990.27 for late payment of tax; $3,009.00 Federal tax deposit penalty; and $982.19 for later payment of tax. Penalty total: $31,243.14. Interest total: $21,148.75.[20]

[18] Hr'g Tr. 84:23 – 85:11, 86:10-21.

[19] Ex. G at 2-3.

[20] Ex. E at 2-3.

c. Civil Penalty Account Transcript (W-2). $39,333.30 Miscellaneous Penalty IRC 6721 Penalty for Intentional Disregard, Failure to File W-2s. Interest Total: $10,403.45.[21]

22. After Trustee Miller succeeded Mr. Claybrook as trustee in 2013, he requested tax refunds from the IRS in the amount of $66,767.37 for certain payroll tax overpayments (the "Overpayment Refund" or "Refund"). The source of the Overpayment Refund was Trustee Miller's filing of payroll tax returns associated with interim distributions made to former employees of the Debtor. Specifically, Trustee Miller made the payroll tax deposits at the time the interim distributions were made, but several of the distributions were not delivered and were returned to Trustee Miller, and several other distribution checks were never cashed. As a result, Trustee Miller sought the Overpayment Refund from the IRS.

23. The IRS processed the Overpayment Refund but retained and applied the entirety of it ($66,767.37) to the Debtor's IRS Tax Obligation ($109,392.50). The Debtor's Form 941 IRS Account Transcript for the period ending December 31, 2005, indicates that the Overpayment Refund was applied to obligations outstanding on the Debtor's Form 941 for the period ending December 31, 2005.[22] The remaining balance of $42,562.13 is currently outstanding on the IRS Tax Obligation.

24. As set forth above, on May 8, 2018, Trustee Miller filed the Disgorgement Motion seeking entry of an order directing disgorgement of compensation

[21] Ex. I at 2-3.

[22] Ex. D at 3.

paid to Mr. Claybrook from his time as the chapter 7 trustee in this case, with such disgorgement to equal no less than $109,329.50 (plus accruing interest), corresponding with the total amount of the IRS Tax Obligation, which Trustee Miller alleges arises from Mr. Claybrook's failure to timely remit payroll taxes, failure to timely file payroll tax returns, and failure to submit the required W-2s to the Government for the period ending December 31, 2005.

25. The Court heard testimony regarding Trustee Miller's Disgorgement Motion and his claim that the IRS Tax Obligation arises from Mr. Claybrook's failure to timely remit payroll taxes, failure to timely file payroll tax returns, and failure to submit the required W-2s to the Government for the period ending December 31, 2005:

26. William Homony is a Partner with the accounting firm Miller Coffey Tate LLP, with whom he has been since 2000. Mr. Homony has a bachelor's degree in accounting and is a certified insolvency and restructuring advisor. For over 18 years, Mr. Homony has dealt with hundreds of cases performing various financial and consulting assignments, including dealing with WARN Act claimants, making distributions to wage claims, and the tax related matters that are involved in paying employees and former employees. Miller Coffey Tate LLP are Trustee Miller's retained accountants and bankruptcy consultants in this case, having been retained for such roles in July 2013. Mr. Homony has worked on this case since that time.

27. Mr. Homony was asked by Trustee Miller where the IRS applied the Overpayment Refund that was due to the Debtor and how Mr. Homony made this determination.

28. On March 14, 2016, the IRS sent Trustee Miller a notice indicating that a $8,189.54 portion of the Refund was applied to the IRS Tax Obligation for the period ending December 31, 2005.[23]

29. On March 21, 2016, the IRS sent Trustee Miller a notice indicating that another $47,368.55 portion of the Refund was applied to the IRS Tax Obligation for the period ending December 31, 2005.[24]

30. On March 21, 2016, the IRS sent Trustee Miller another notice indicating that another $11,208.28 portion of the Refund was applied to the IRS Tax Obligation for the period ending December 31, 2005.[25]

31. Mr. Homony thereafter searched for the relevant tax returns for the period ending December 31, 2005, including requesting a copy of the same from the IRS. To date, Mr. Homony has not found a copy of the tax returns in the Debtor's files, despite Mr. Claybrook's testimony that he did turn them over to Trustee Miller along with all of the Debtor's files, at the end of his term as trustee. Also, because the relevant tax returns were for a period longer than 10 years old, the IRS is no longer in possession of returns pertaining to that period. Mr. Homony has, therefore, had no occasion to review the filed tax returns for the period ending December 31, 2005.[26]

[23] Ex. F; Hr'g Tr. 19:10 – 21:13.
[24] Ex. D; Hr'g Tr. 19:10 – 21:13.
[25] Ex. H; Hr'g Tr. 19:10 – 21:13.
[26] Hr'g Tr. 19:3-19; Ex. J at 3.

32. Mr. Homony reviewed the IRS account transcripts of the Debtor's Forms 940, 941, and W2s (collectively, the "IRS Account Transcripts") for the period ending December 31, 2005 and concluded:

a. Form 940. The 940 Account Transcript for the period ending December 31, 2005 reflects that penalties were assessed in the amount of $1,591.62 on May 8, 2006 for: filing Form 940 after the due date ($716.23),[27] tax deposit penalty ($795.81), and late payment of tax penalty ($79.58). Additionally, interest was assessed by failing to pay the assessed penalties on May 8, 2006 ($103.12), November 17, 2014 ($819.17), November 23, 2015 ($77.83) and March 21, 2016 ($14.72). The total amount due to the IRS just prior to the application of the Overpayment Refund was $2,606.46. After application of a $2,606.48 portion of the Overpayment Refund, the balance was satisfied in full.[28]

b. Form 941. The 941 Account Transcript for the period ending December 31, 2005, reflects that penalties were assessed on May 1, 2006 in the amount of $32,362.34 for filing Form 941 after the due date ($12,496.21),[29] tax deposit penalty ($13,884.67),[30] and late payment of tax penalty ($1,990.27); on June 5, 2006 for tax deposit penalty ($3,009.00); and on November 16, 2009 for late payment of tax penalty ($982.19). Additionally, interest was assessed for failing to pay the assessed penalties on May 1, 2006

[27] The Form 940 for 2005 was due no later than January 31, 2006. Per the IRS transcript, the Form 940 for that period was received on March 30, 2006. *See* Hr'g Tr. 31:1-9; Ex. G at 2.

[28] *See* Hr'g Tr. 31:1 – 32: 4; Ex. G.

[29] The 941 for 2005 for the fourth quarter was due no later than January 31, 2006. Per the IRS transcript, the tax return for that period was received on March 10, 2006. *See* Ex. E at 2.

[30] This is exactly 10% of the tax reported ($138,846.75) on the return for the period ending December 31, 2005. *See* Hr'g Tr. 22:9 – 22:16, 26:18 – 22; Ex. E at 3. Mr. Homony testified that this "could be assessed for a number of reasons," including untimely deposit of payroll taxes and not submitting the payroll taxes electronically or through a financial institution. *See* Hr'g Tr. 26:22 – 27:6.

($1,831.04), November 17, 2014 ($17,610.99), and November 23, 2015 ($1,706.72).[31] Finally, there was a credit ($55,909.68) transferred in from the 941 for the period ending December 31, 2002 (prior to the Petition Date).[32] Mr. Homony concluded that all of the Form 941 penalties were calculated and assessed by the IRS "within a reasonable degree of certainty" because one specific penalty, the tax deposit penalty ($13,884.67), was accurately calculated at 10 percent of the return amount ($138,846.75), which the IRS penalty provisions provide as an appropriate penalty rate.[33] Mr. Homony further concluded that Form 941 interest calculations, while "a little trickier," were also within a "range of reasonableness" because they were a result Mr. Claybrook's actions in filing the late forms.[34]

c. Form W-2s. The Civil Penalty Account Transcript for the tax period ending December 31, 2005, reflects that a civil penalty was assessed in the amount of $39,333.30 on December 29, 2008 for a failure to file Form W-2s with the Social Security Administration. Interest was subsequently assessed on November 17, 2014 ($8,909.77), and November 23, 2015 ($1,493.68). The total amount due to the IRS just prior to the application of the Overpayment Refund was $49,736.75. After application of a $7,716.81

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[31] Hr'g Tr. 26 – 27:11; Ex. E.

[32] Significantly, Mr. Homony speculated that this $55,909.68 is the remainder of the 2006 Claybrook Payments after the IRS applied a portion of it to the Debtor's outstanding obligations for the tax period ending December 31, 2002. *See* Hr'g Tr. 27:16 – 28:11. However, Mr. Homony has had no occasion to review the Form 941 or account transcript for that period. *Id.* at 28:12-22.

[33] *See* Hr'g Tr. 30:3-6.

[34] *See* Hr'g Tr. 30:7-13.

portion of the Overpayment Refund, the balance due was $42,562.13, including $542.19 in ongoing interest charges.[35]

33. Regarding the 2006 Claybrook Payments, Mr. Homony testified that $78,000 in checks from the Claybrook Payments were cashed and credited by the IRS, as reflected on the From 941 for that period.[36] Mr. Homony also testified on cross-examination that an additional $60,177.92 in checks from the Claybrook Payments were cleared to the IRS in March 2006, as reflected in the Debtor's bank statement,[37] but that the $60,177.92 amount is not reflected in that exact amount on the 941 Account Transcript for that period.[38]

34. Significantly, the Form 941 IRS Account Transcript for the period ending December 31, 2005, reflects a tax deposit penalty of $3,009.00, which is 5 percent of $60,177.92, which is the amount that was cleared to the IRS but not reflected on this transcript.[39]

35. To date, Mr. Homony has not inquired with the IRS about the $60,177.92 in checks that were cashed but not reflected as credited in that exact amount on the Form 941 for the period of ending December 31, 2005.[40]

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[35] *See* Hr'g Tr. 36:2-8; Ex. I.

[36] *See* Hr'g Tr. 45:10-13; Ex. A; Ex. E.

[37] *See* Ex. A.

[38] *See* Hr'g Tr. 44:24 – 45:20.

[39] *See* Hr'g Tr. 49:16 – 50:2; Ex. E.

[40] *See* Hr'g Tr. 51:14-16.

36. Mr. Homony testified that he speculates that approximately $5,000 of the $60,177.92 was used by the IRS to pay down an outstanding balance due from the Debtor's 941 for the period ending December 31, 2002, as refenced earlier. Mr. Homony further speculates that the credited amount of $55,909.60 that is reflected on the Form 941 Account Transcript for the period ending December 31, 2005, is the remainder of the $60,177.92 Mr. Claybrook deposited to the IRS.[41] Mr. Homony testified that, "just from experience," the IRS typically first applies a refund owed to a party to that party's longest outstanding tax obligation.[42] However, the IRS policy in 2005 was to apply deposits to the most recent tax liability within the quarter.[43] Therefore, Mr. Homony's experience is seemingly in conflict with the IRS's stated policy in this regard.

37. If the $60,177.92 deposit was not credited to the Debtor's 941 Account, then the current balance of the Debtor's IRS Tax Obligation ($42,562.13) is an incorrectly calculated amount. That is, an additional $60,177.92 credit to the Form 941 for the period ending December 31, 2006, after recalculating the relevant penalties and interest, would result in a remaining IRS Tax Obligation of approximately $14,000.[44]

38. Mr. Homony testified that there are no records from which to definitively determine whether the $60,177.92 was in fact credited to the Debtor's IRS Tax Obligation.[45]

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[41] *See* Hr'g Tr. 52:15 – 54:2.

[42] *See* Hr'g Tr. 28:14-22.

[43] *See* Hr'g Tr. 55:7-24; Ex. O at 22.

[44] *See* Hr'g Tr. 58:13 – 62:5.

[45] *See* Hr'g Tr. 67:17-25.

39. Mr. Homony received the IRS Account Transcripts in March of 2016. Within a few months, he determined that the penalties were reasonable and the IRS setoff was valid.[46]

40. The Court finds that Mr. Homony's determination regarding the accuracy of the IRS Tax Obligations is replete with speculation and inconsistencies. Therefore, the Court finds that Mr. Homony's determination in this regard is unreliable.

41. To date, Trustee Miller has not sought to avoid the IRS setoff, nor has an avoidance action been considered regarding the IRS setoff.

CONCLUSIONS OF LAW

1. This Court has jurisdiction to consider and determine this matter pursuant to 28 U.S.C. § 1334. This is a core proceeding pursuant to 28 U.S.C. § 157(b). Venue is proper before this Court pursuant to 28 U.S.C. §§ 1408 and 1409.

(a) Trustee Miller Has Not Satisfied His Burden of Proving that the Postpetition Assessments Accurately Resulted from Mr. Claybrook's Actions.

2. The amount of compensation that can be awarded to trustees appointed in a case under chapter 7 is governed by sections 326(a) and 330.[47]

3. Under section 330, a trustee may be awarded "reasonable compensation for actual, necessary services rendered . . . and . . . reimbursement for

[46] *See* Hr'g Tr. 69:23-70:18.

[47] *See Staiano v. Cain (In re: Lan Associates XI, L.P.)*, 192 F.3d 109, 115 (3d Cir. 1999).

actual, necessary expenses."[48] Generally, in order to determine what amount constitutes "reasonable compensation," a court must consider the following non-exclusive factors:[49]

> (A) the time spent on such services;
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> (B) the rates charged for such services;
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> (C) whether the services were necessary to the administration of, or beneficial at the time at which the service was rendered toward the completion of, a case under this title;
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> (D) whether the services were performed within a reasonable amount of time commensurate with the complexity, importance, and nature of the problem, issue, or task addressed; and
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> (E) whether the compensation is reasonable based on the customary compensation charged by comparably skilled practitioners in cases other than cases under this title.

4. Compensation of trustees in chapter 7 cases bypasses the typical considerations of section 330(a)(3). Instead, such compensation is governed by the percentages contained under section 326, which establishes a rebuttable presumption that the maximum percentage allowed under section 326 is reasonable.[50]

5. Section 330(a)(2) explicitly allows for the reduction of a fee requested by a trustee based on a motion of the court, the United States Trustee, the trustee for the Debtor, or any party in interest.[51] In the event of ethical violations, breaches of fiduciary

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[48] *In re Pivinski*, 366 B.R. 285, 288 (Bankr. D. Del. 2007) (citing 11 U.S.C. § 330(a)(1)(A)-(B)).

[49] 11 U.S.C. § 330(a)(3)(A)-(E); *see In re Lan Assocs. XI, L.P.*, 192 F.3d 109, 123 (3d Cir. 1999) (stating that section 330 reasonableness factors are non-exclusive).

[50] *See* 11 U.S.C. § 326; *Fear v. United States Tr. (In re Ruiz)*, 541 B.R. 892, 896 (B.A.P. 9th Cir. 2015); *In re Scoggins*, 517 B.R. 206, 227 (Bankr. E.D. Cal. 2014).

[51] 11 U.S.C. § 330(a)(2).

duty, negligence or wrongdoing, a trustee's requested compensation may be denied in whole or in part.[52] An additional remedy is disgorgement of the trustee's fees.[53]

6. A chapter 7 trustee serves as a representative of the estate and as a fiduciary of the estate for the benefit of the creditors.[54] In this capacity, the trustee's duties include the duty to timely file appropriate tax returns and pay tax liabilities on behalf of the Debtor.[55]

7. If a trustee fails to timely file tax returns or pay taxes on behalf the Debtor, the IRS may impose penalties on the Debtor, "unless it is shown that such failure is due to *reasonable cause* and not *willful neglect*."[56] Treasury Regulations set forth what a taxpayer must show to establish "reasonable cause": a filer must prove that either (1) the failure was due to impediments that were beyond the filer's control, or (2) there were significant mitigating factors with respect to the failure to file.[57] In *United States v Boyle*, the Supreme Court clarified that to show "reasonable cause," the filing entity must

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[52] *See In re All Island Truck Leasing Corp*., 546 B.R. 522, 534 (Bankr. E.D.N.Y. 2016) (citing *In re Thorogood*, 22 B.R. 725, 728 (Bankr. E.D.N.Y. 1982)); *In re DiLieto*, 468 B.R. 510, 540-41 (Bankr. D. Conn. 2012) (citing *Damon & Morey, LLP*, v. Slater, No. 97-CV-0080E, 1998 U.S. Dist. LEXIS 341, at *14-15 (W.D.N.Y. January 14, 1998)); *see also In re Evangeline Refining Co.,* 890 F.2d 1312, 1323 (5th Cir. 1989)).

[53] *See Trustee Handbook* at 6-4.

[54] 11 U.S.C. § 323(a); *see In re Jack Greenberg, Inc.*, 189 B.R. 906, 910 (Bankr. E.D. Pa. 1995) (citing *In re Manfred*, 153 Bankr. 430, 439 (Bankr. D.N.J. 1993)).

[55] *See* 11 U.S.C. § 704(a)(8); 26 U.S.C. § 6012(b)(4); 28 U.S.C. § 960; *Trustee Handbook* at 4-7; *see also Frost v. Hussain (In re Hussain)*, 2010 U.S. Dist. Lexis 128988 at *5-6 (D.N.J. Dec. 7, 2010) (citing 26 U.S.C. § 6012(b)(4)).

[56] 26 U.S.C. § 6651(a) (emphasis added); *see United States v. Boyle*, 469 U.S. 241, 247 (1985); *Estate of Thouron v. United States, 752 F.3d 311, 314 (3d Cir.2014); Sanderling, Inc. v. C.I.R.,571 F.2d 174, 179 (3rd Cir.1978)*; *In re Refco Pub. Commodity Pool, L.P.*, 554 B.R. 736, 742 (Bankr. D. Del. 2016).

[57] Treas. Reg. § 301.6724–1(a)(2)(i)–(ii); *see Estate of Thouron*, 752 F.3d at 314 (discussing reasonable cause under the Treasury Regulations); *Refco*, 554 B.R. at 742 (same).

demonstrate the "exercise of ordinary business care and prudence and the inability to file the return within the prescribed time."[58] *Boyle* further clarified that "the term willful neglect may be read as meaning a conscious, intentional failure or reckless indifference."[59]

8. The IRS has instructed employers who file late returns or make late deposits to attach an explanation of their "reasonable cause," if any, in order to potentially avoid late penalties.[60]

9. Courts have found reasonable cause in such instances where a taxpayer relied on the IRS's inaction in conjunction with IRS audits,[61] where there were "conflicting rulings or decisions, or ambiguities in the law,"[62] where there was confusion by the IRS itself regarding both the law and its application,[63] and, also, where a trustee made efforts to timely file tax returns but was ultimately unable to do so because of an inability to obtain necessary information.[64] In contrast, reasonable cause has not been found where a trustee was merely preoccupied with other responsibilities and failed to take any steps to prevent a late filing.[65]

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[58] *Boyle*, 469 U.S. at 247; *see Estate of Thouron*, 752 F.3d at 314; *Sanderling* 571 F.2d at 179.
[59] *Boyle*, 469 U.S. at 245.
[60] *See* Internal Revenue Service, (Circular E), Employer's Tax Guide (Rev. January 2005), at 24; Ex. E.
[61] *See, e.g., Dana Corporation v. U.S.*, 764 F. Supp. 482, 488 (N.D. Ohio 1991); *Gilmore v. U.S.*, 443 F. Supp. 91, 99–100 (D. Md. 1977).
[62] *See Sanderling,* 571 F.2d at 179; *Gilmore,* 443 F. Supp. at 99; *United States v. Northumberland Ins. Co., Ltd.,* 521 F. Supp. 70, 79 (D.N.J. 1981).
[63] *See Sanderling*, 571 F.2d at 177–79.
[64] *Refco*, 554 B.R. at 747.
[65] *In re Colony Beach & Tennis Club*, Ltd., 578 B.R. 909 (Bankr. M.D. Fla. 2017) (holding that a trustee who did not file a timely return due to being involved in complex litigation which required his full attention failed to show "reasonable cause" because trustee did not file for an extension for the return, did not delegate the obligation to file the extension to an accountant, and there was no evidence that trustee was unable to comply with his obligations because of events beyond his control).

10. Willful neglect has been found where a debtor knowingly and repeatedly failed to file tax returns or pay its tax debts in order to satisfy other obligations instead.[66] In contrast, willful neglect has not been found where a trustee made reasonable efforts to timely file tax returns but was ultimately unable to do so because he could not obtain the relevant information needed to file a return before the deadline.[67] A finding of reasonable cause necessarily precludes a finding of willful neglect, and a finding of willful neglect necessarily precludes a finding of reasonable cause. Accordingly, anything less than willful neglect may be excused by a finding of reasonable cause.

11. To succeed on the Disgorgement Motion, Trustee Miller must prove by a preponderance of the evidence that (i) Mr. Claybrook failed to perform his duty to appropriately satisfy the Debtor's tax-related obligations, (ii) that such failure resulted in the IRS Tax Obligation, and (iii) the IRS accurately calculated the amounts associated with the IRS Tax Obligation. If Trustee Miller satisfies his burden, then Mr. Claybrook carries the burden of proving he had reasonable cause and lacked willful neglect.[68]

12. Mr. Claybrook's duties as the chapter 7 trustee included the timely filing of IRS tax returns and submission of all relevant tax forms on behalf of the Debtor.

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[66] *See, e.g.*, *In re Johnson Systems, Inc.*, 432 B.R. 306, 317 (Bankr. N.D. Ala. 2010) (finding willful neglect where a debtor's principals deliberately failed to pay taxes and file returns in order to avoid depleting funds that would pay their own salaries); *In re McTyre Trucking Co., Inc.*, 223 B.R. 588, 593 (Bankr. M.D. Fla. 1998) (finding willful neglect where debtor knowingly neglected to pay federal payroll taxes for seven years in order to pay other creditors from available funds).

[67] *Refco*, 554 B.R. at 747 (finding there was no willful neglect where a trustee made repeated efforts to obtain the necessary information to file the relevant returns and took steps to comply with the tax laws).

[68] *See Estate of Thouron*, 752 F.3d at 313 (citing *Boyle*, 469 U.S. at 245).

No one disputes that Mr. Claybrook did not timely file Forms 940 and 941 for the period ending December 31, 2005, despite knowing the appropriate due date (January 31, 2006). Mr. Claybrook testified that the reason he did not timely file the Forms 940 and 941 was because he was waiting to pay approximately twenty of the WARN Plaintiffs in accordance with the WARN Act Stipulation, which required contacting the relevant Plaintiffs and determining their appropriate addresses.[69] The amount of checks paid to the Plaintiffs would ultimately determine the amounts to be properly reported on Forms 940 and 941. After making several attempts, using several databases, the checks were returned undeliverable. Mr. Claybrook ultimately was able to obtain the employees' information from their class counsel by March of 2006, after the due date for the Forms 940 and 941, at which point he filed the relevant Forms and made the correct deposits.

13. No one disputes that Mr. Claybrook failed to ever file Form W-2's with the Social Security Administration. Mr. Claybrook never provided these Form W-2s because he was not able to comply with the Social Security Administration's instructions on sending them. Sending these Forms in compliance with the Social Security Administration's instructions required a software that Mr. Claybrook did not have. Mr. Claybrook sought to use the software of other businesses, but no one he contacted was willing to provide their software to him. Ultimately, Mr. Claybrook made a business judgment to not make any further efforts to send the Form W-2's to the Social Security Administration.[70]

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[69] Hr'g Tr. 77:11 – 78:18.

[70] Hr'g Tr. 84:23 – 85:11, 86:10-21.

14. In *Refco*, Judge Shannon did not find "willful neglect" where a Debtor was fully aware of its filing obligations and made repeated efforts to obtain the information necessary for making the appropriate tax filings but ultimately could not file a timely return.[71] Likewise, here, the Court concludes there was no "willful neglect" regarding Forms 940, 941, and W-2 considering that Mr. Claybrook did not carelessly sit on his hands and intentionally or recklessly ignore the filing deadlines. Instead he and his team engaged in repeated efforts to collect the correct information from the Plaintiffs in order to distribute their payments before filing the relevant Forms, with correct information, with the IRS. Likewise, Mr. Claybrook attempted to file the Form W-2's. He sought to acquire the appropriate software needed to file the Forms, but he was ultimately unable to do so. These efforts preclude a finding of willful neglect.

15. Considering, however, that Mr. Claybrook did not seek an extension, did not otherwise contact the IRS regarding the late filings, and did not attach an explanation as to any reasonable causes, the Court finds that Mr. Claybrook did not exercise ordinary business care and prudence in filing the Forms and making the deposits. Mr. Claybrook could have potentially avoided any penalties by simply attaching an explanation of his reasons causing the Forms 940 and 941 late filings and deposits and for not filing Form W2s. Therefore, the Court concludes that Mr. Claybrook's conduct in this instance was a breach of his duty to timely file the relevant

[71] *Refco*, 554 B.R. at 747.

IRS returns and make timely deposits and he has not shown "reasonable cause" for breaching this duty.

16. That is not the end of the inquiry, however, as there remains the question of what damages, if any, exactly resulted from Mr. Claybrook's failure to file the relevant returns with the IRS. The IRS Account Transcripts indicate that penalties were assessed against the Debtor resulting from the late filing of the Forms for the period ending December 31, 2005. It is unclear, however, whether the penalties were correctly calculated and whether certain of the 2006 Claybrook Payments were accounted for in the penalty assessments. Particularly significant is the absence of a clear explanation as to why $60,177.92 in checks from the 2006 Claybrook Payments is not accounted for in that exact amount on the Debtor's Form 941 IRS Account Transcript for the period ending December 31, 2005. Mr. Homony speculates that approximately $5,000 of the $60,177.92 was applied to another delinquent tax obligation pertaining to the period ending December 31, 2002, prior to the Petition Date, and that a $55,909 credited amount that is reflected on the Form 941 for the 2005 period is the remainder of the $60,177.92. Mr. Homony does not provide any evidentiary support for this conclusion, however, as he has neither reviewed the tax return for the 2002 period nor is there an IRS Account Transcript available from that period to corroborate his speculation. Additionally, this explanation seemingly conflicts with the IRS's stated policy of applying deposits to the most recent tax liability within a quarter. According to that policy, the $60,177.92 that Mr. Claybrook deposited in 2006 should have been applied to the IRS Tax Obligation for that quarter (2005) before applying any amounts to the outstanding amount from 2002.

Casting even greater uncertainty on Mr. Homony's speculation, the 941 Account Transcript reflects a $3,009.00 "Federal tax deposit penalty," which is approximately 5 percent of $60,177.92, assessed on June 5, 2006. This may indicate that the IRS did not account for $60,177.92 in checks that the Debtor's bank account record shows were cleared to the IRS on March 21, 2006. Ultimately, without the relevant records, Trustee Miller cannot establish that the penalties and interest were properly assessed. Therefore, the Court concludes that Trustee Miller has not satisfied his burden of proving that the IRS Tax Obligation was accurately calculated and that any damages incurred to the Debtor resulted from Mr. Claybrook's failure to timely file the relevant Forms or remit payments.

(b) The Claims for the Amounts Assessed in the IRS Account Transcripts were Non-Administrative and Improperly Set Off.

17. Even if the IRS Tax Obligation was properly calculated, the IRS was not entitled to a setoff.

18. Code section 503(b)(1)(B)(i) grants administrative expense priority to "any tax incurred by the Debtor, whether secured or unsecured, including property taxes for which liability is in rem, in personam, or both, *except a tax of a kind specified in section 507(a)(8) of this title*."[72] Section 503(b)(1)(C) grants administrative expense priority to "any fine, penalty, or reduction in credit relating to a tax of a kind specified in subparagraph (B) of this paragraph."[73] Accordingly, taxes entitled to priority under section 507(a)(8)

[72] 11 U.S.C. § 503(b)(1)(B)(i) (emphasis added).
[73] 11 U.S.C. § 503(b)(1)(C).

are not administrative expense claims and, as a result, penalties relating to such priority tax claims are not administrative expense claims.

19. The Plaintiffs' WARN Act wage claims arose and were earned upon termination without notice prior to the Petition Date.[74] Considering the priority to be accorded to withholding taxes on prepetition wage claims, this Court follows the Supreme Court's directive that "[w]ithholding taxes are, in full effect, part of the claims themselves and derive from and are carved out of the payment of those claims…Conceptually the tax payments should be treated in the same way as the wages from which they derive and of which they are a part."[75] Therefore, because the WARN Act wage claims are priority claims, claims for taxes withheld from the WARN Plaintiffs' wages are also priority claims pursuant to section 507(a)(8)(C).[76]

20. Similarly, the Debtor's portion of FICA and Medicare are priority tax claims pursuant to section 507(a)(8)(D), which provides eighth priority treatment to "an employment tax on a wage, salary, or commission of a kind specified in paragraph (4) of this subsection earned from the debtor before the date of the filing of the petition, whether

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[74] *See In re Powermate Holding Corp.*, 394 B.R. 765, 776-77 (Bankr. D. Del. 2008) (holding that WARN Act claims of employees terminated without notice immediately prior to the bankruptcy filing were priority claims, not administrative claims, because their right to payment vested prepetition).

[75] *Otte v. United States*. 419 U.S. 43, 56-57 (1974) (holding that taxes withheld from prepetition wages that were not due until after the bankruptcy filing were not entitled to first priority as costs of administration under Section 64a of the Bankruptcy Act but were entitled to second priority because they are attributable to the availability of funds to pay priority wage claims); *see In re Goody's LLC*, 508 B.R. 891, 900 (Bankr. D. Del. 2014) (discussing and applying *Otte,* which arose under section 64a of the Bankruptcy Act, to a case arising under the Bankruptcy Code, and holding that taxes arising from prepetition wages were not entitled to administrative status); *see also In re Arlan's Dep't Stores, Inc.*, 3 B.R. 700, 702 (S.D.N.Y. 1980) (citing *Otte*).

[76] 11 U.S.C. § 507(a)(8)(C).

or not actually paid before such date."[77] Because the WARN Act claims were earned prior to the Petition Date and are entitled to priority treatment pursuant to Section 507(4), the employers FICA and Medicare contribution taxes on those claims are priority claims, not administrative expense claims.[78]

21. Because the taxes Mr. Claybrook paid pursuant to the WARN Act Settlement Stipulation are priority claims, the penalties assessed are general unsecured claims not entitled to priority.[79] Section 507(a)(8)(G) provides eighth priority treatment to "a penalty related to a claim of a kind specified in this paragraph and in compensation for actual pecuniary loss."[80] Penalties that are not in compensation for a pecuniary loss are not entitled to priority treatment.[81] Here, the penalties assessed on Forms 940, 941, and Civil Penalty (W-2) are punitive, as they do no compensate the IRS for a pecuniary loss. Accordingly, the IRS's penalty claims are not entitled to priority. Moreover, because

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[77] *Id*. at § 507(8)(D).

[78] *See Alberts v. HCA, Inc. (In re Greater Southwest Community Hospital Corp. I)*, 365 B.R. 293, 309 (Bankr. D.C. 2006) (holding that "[w]hen employment taxes relate to wages or salaries earned prepetition but not paid until after the filing in bankruptcy, they are specifically excluded from administrative status by virtue of sections 503(b)(1)(B)(i) and 507(a)(8)(D)") (quoting 4 Collier on Bankruptcy ¶ 503.07[2][d] (15th ed.2006)).

[79] Trustee Miller's reliance on *Nicholas v. United States*, 384 U.S. 678 (1966), is misguided. The penalties there were allowed administrative status under section 64a(4) of the Bankruptcy Act because they arose from wages incurred and paid during the debtor's arrangement proceeding under Chapter XI. Here, as stated earlier, the taxes arise from prepetition wages. Therefore, *Nicholas* is inapposite and inapplicable. Furthermore, to the extent that the court in *In re 1800 Ideas.com, Inc.*, 527 B.R. 701, 704 (Bankr. S.D. Cal. 2015), also misreads this distinction in *Nicholas*, it too is inapposite and inapplicable to the facts of this case.

[80] 11 U.S.C. § 507(a)(8)(G).

[81] *See United States v. Reorganized CF&I of Utah Fabricators, Inc.*, 518, U.S. 213, 226 (1996) ("A tax is an enforced contribution to provide for the support of government; a penalty, as the word is here used, is an exaction imposed by statute as punishment for an unlawful act."); *see also In re Pheasant Cove, LLC.*, No. 07-0058 TLM, 2008 WL 187529, at *5 (Bankr. D. Idaho Jan. 18, 2008) (discussing the distinction between pecuniary and non-pecuniary penalties in the context of sections 507(a)(8)(G) and 726(a)(4)).

this is a chapter 7 case, section 726(a)(4) subordinates these claims to the allowed claims of other unsecured creditors.[82]

22. Finally, the IRS does not have an allowed claim for interest pursuant to sections 502(b)(2) and (i). Section 502(i) provides as follows:[83]

> A claim that does not arise until after the commencement of the case for a tax entitled to priority under section 507(a)(8) of this title shall be determined, and shall be allowed under subsection (a), (b), or (c) of this section, or disallowed under subsection (d) or (e) of this section, the same as if such claim had arisen before the date of the filing of the petition.

Section 502(b)(2) provides that claims for unmatured interest that accrue after the bankruptcy filing cannot be allowed claims.[84] Accordingly, section 502(b)(2) prohibits payment of postpetition interest on prepetition unsecured claims, including prepetition tax claims.[85]

23. Therefore, the Court concludes that the IRS's application of the Refund to the IRS Tax Obligation was an impermissible setoff.[86] Trustee Miller should have pursued recovery of the Refund from the IRS before seeking to disgorge compensation Mr. Claybrook was paid over twelve years ago. Additionally, the IRS's

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[82] *See* 11 U.S.C. § 726(a)(4).

[83] *Id*. at § 502(i).

[84] *Id*. at § 502(b)(2).

[85] *See Fullmer v. United States (In re Fullmer)*, 962 F.2d 1463 (9th Cir. 1992) (noting that unmatured interest, including interest accruing postpetition on a prepetition tax claim is disallowed against the bankruptcy estate), *abrogated on other grounds by Raleigh v. Illinois Dept. of Revenue*, 530 U.S. 15, 26 (2000).

[86] *See, e.g., In re Semcrude, L.P.*, 399 B.R. 388, 393 (Del. Bankr. 2009) (for setoff to be permissible, the debts to be offset must be mutual, prepetition debts).

claims were not entitled to administrative priority, so any payment to satisfy their claims would have to be in accordance with payments made to their proper class.

(c) Trustee Miller's Disgorgement Motion is not Barred by the Doctrine of Laches.

24. Mr. Claybrook asserts that the doctrine of latches should bar Trustee Miller's Disgorgement Motion. Laches bars an action in "extraordinary cases" where the plaintiff unreasonably delayed bringing an action, with such delay resulting in unfair prejudice to the defendant.[87] Thus, laches requires proof of three elements: (i) knowledge by a claimant; (ii) unreasonable delay in bringing the claim; and (iii) prejudice to the defendant.[88] The Court is not persuaded that prongs 2 and 3 exist here.

25. Trustee Miller was appointed in 2013 and knew about the IRS Tax Obligation since at least March 2016 but did not file the Disgorgement Motion until more than two years later. During a portion of this time, however, Mr. Homony investigated the grounds for the IRS Tax Obligation, including contacts with the IRS and Mr. Claybrook to obtain the relevant underlying tax returns and IRS Account Transcripts. Therefore, Trustee Miller did not unreasonably delay bringing the Disgorgement Motion. The Court concludes such delay was not unreasonable given Trustee Miller's various duties in administering the Estate. But even if the delay were found to be unreasonable, Mr. Claybrook was not unduly prejudiced by it. There is no reason to believe that any

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[87] *In re Bressman*, 874 F.3d 142, 149 (3d Cir. 2017); *see In re Energy Future Holdings Corp.*, 561 B.R. 630, 645 (Bankr. D. Del. 2016); *In re Am. Home Mortg. Holding*, 458 B.R. 161, 172 (Bankr. D. Del. 2011); *Whittington v. Dragon Group*, LLC, 991 A.2d 1, 8 (Del. Supr. 2009).

[88] *See Energy Future Holdings*, 561 B.R. at 645.

evidence that was unavailable when the Disgorgement Motion was brought would have been available when Trustee Miller first had knowledge of the IRS Tax Obligation in 2016. Among the missing documents that are particularly significant are the tax returns for the period ending December 31, 2005, and the returns and IRS Account Transcripts for the period ending December 31, 2002. Both sets of documents are outside the 10-year period which the IRS retains such documents. And Mr. Claybrook does not assert that the documents were accessible to him or any other party in 2016. Accordingly, the two-year delay in bringing the Disgorgement Action did not prevent Mr. Claybrook from further investigating the IRS's setoff. The Court, therefore, concludes that laches does not apply here.

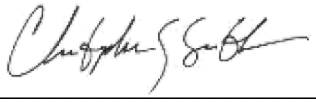
(d) Claybrook's Entitlement to Additional Compensation

26. Mr. Claybrook's final argument is that he should not be required to disgorge funds because he was theoretically entitled to receive $325,51154 in additional compensation pursuant to the trustee compensation formula under section 326. The Court rejects this argument. Even if Mr. Claybrook was theoretically entitled to further compensation, he ultimately did not seek such additional compensation, and the Court will not now retrospectively consider compensation that Mr. Claybrook never requested.

CONCLUSION

For the reasons set forth herein, the Trustee Miller's Disgorgement Motion will be denied.

An order will be issued.



Christopher S. Sontchi
Chief United States Bankruptcy Judge

Dated: July 1, 2019