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Liquidating Trusts - Cleanup Crew: the Work of the Litigation Trust

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The use of a liquidating trust may be an efficient and beneficial option for a debtor facing bankruptcy. While the process of a liquidating trust may appear similar to a chapter 7 liquidation from an overview prospective, the combination of reducing the oversight of the bankruptcy court with the efficiency and skill of the liquidating trustee will likely lead to better results and less headache for the debtor and its creditors. Prior to making the decision of using a liquidating trust the debtor will need to think about how it will affect the creditors compared to a standard chapter 7 liquidation, because the chapter 11 plan will still need to pass the hurdles of §1129 and be confirmed. Once a liquidating trust is formed, another issue is determining which courts have jurisdiction, and why, over disputes that may arise. If a debtor determines that a liquidating trust would be of benefit, they need to be prepared that post-confirmation issues may be heard in a non-bankruptcy forum.

I. Functions of a Liquidating Trust:

To assist in the wind-up or reorganization of a debtor corporation[1], section 1123(b)(3)(B) of the U.S. Bankruptcy Code expressly allows for the creation of a liquidating trust –a state-law trust wherein a debtor may vest assets in a "representative of the estate" for the purpose of retaining and enforcing any claim or interest belonging to the debtor or the estate. 11 U.S.C. §1123; *In re Insilco Techs., Inc.,* 480 F.3d 212, 214 n.l (3d Cir. 2007). The liquidating trust is a legal entity separate from the debtor organization, and it is created and governed by a plan of liquidation, reorganization, and/or settlement agreement and applicable non-bankruptcy law and non-bankruptcy agreements that must be approved by the bankruptcy court. *See, e.g.*, *Binder v. Price Waterhouse & Co., LLP* (*In re Resorts Int'l, Inc.*), 372 F.3d 154, 165 (3d Cir. 2004). A debtor who wants to reorganize and rebuild its business, or simply move on, may create a liquidating trust and place intangible or illiquid assets in the trust such that it is not burdened with the litigation claims, investigations, and avoidance actions that may take years to resolve and exist for the

[1] Terms used herein have the meanings ascribed to them in the Bankruptcy Code.

benefit of the creditor body. Mark L. Prager & Geoffrey S. Goodman, *The Growing Use of Liquidating Trusts in Chapter 11 Cases: Practical Considerations*, 17 COM LENDING REV. 30, 34 (2002).

Liquidating trusts monetize estate assets post-confirmation in order to make distributions pursuant to priority schemes approved under the confirmed chapter 11 plan. If approved, the liquidating trust agreement ("LTA") will typically be executed as of the effective date of the plan and will form the liquidating trust pursuant to applicable state law. *Id.* at 32. The LTA forms the trust, and the liquidating trustee primarily functions to manage the debtor's assets in the trust where the creditors are the beneficiaries. The trustee will then liquidate the trust assets, pursue potential recoveries related to litigation, analyze and reconcile claims, prepare and make distributions to creditors or holders of allowed claims, and dissolve the debtor's entities, each to the extent provided under the confirmed chapter 11 plan.

II. Intersection with Bankruptcy

Pursuant to 11 U.S.C. § 1141(b), all property of the estate vests in the reorganized debtor upon the confirmation of a plan, and the bankruptcy estate ceases to exist. *Venn v. Kinjite Motors, Inc. (In re WMR Enterprises, Inc.)*, 163 B.R. 887, 889 (Bankr. N.D. Fla. 1994) ("upon confirmation of the plan of reorganization, all property of the estate is vested in the reorganized debtor pursuant to 11. U.S.C. § 1141(b) and the bankruptcy estate is essentially dissolved."). Vesting of assets in a reorganized debtor is typical upon confirmation of a plan. *See, e.g.*, *In re Lisenmeyer*, 280 B.R. 828 (E.D. Mich. 2002) (holding gain from post-confirmation sale of stock was asset of the reorganized debtor and not the estate because stock invested in reorganized debtor upon confirmation of chapter 11 plan). For purposes of bankruptcy, a liquidation trust has been defined as a trust established under a chapter 11 plan "to liquidate the debtor's assets, to resolve claims, to prosecute avoidance actions and disburse proceeds to creditors." American Bankruptcy Institute, A PRACTITIONER'S GUIDE TO LIQUIDATION AND LITIGATION TRUSTS 254 (2015). Section 1123(b)(3)(B) of the Bankruptcy Code expressly permits the formation of a liquidation trust,

allowing a debtor to vest property and other rights in a "representative of the estate" for the purpose of retaining and enforcing any claim or interest belonging to the debtor or the estate.

When the debtor's estate's assets are vested in a liquidating trust, rather than with a reorganized debtor, the jurisdictional boundaries of the bankruptcy court as set forth in 28 U.S.C. § 1334(b) are sometimes overlooked. Chad P. Pugatch et al., *The Lost Art of Chapter 11 Reorganization*, 19 U. FLA. J.L. & PUB. POL'y 39, 64 (2008). Because the debtor's estate ceases to exist once confirmation has occurred, "at the most literal level, it is impossible for the bankrupt debtor's estate to be affected by a post-confirmation dispute." *Binder v. Price Waterhouse & Co., LLP (In re Resorts Int'l, Inc.)*, 372 F.3d 154, 165 (3rd Cir. 2004)*; see also H & L Developers v. Arvida/JMB Partners (In re H & L Developers),* 178 B.R. 71, 76 (Bankr. E.D. Pa. 1994) (noting that the court's jurisdiction begins to weaken once a plan is confirmed); *Eastland Partners Ltd. v. Brown (In re Eastland Partners Ltd.),* 199 B.R. 917, 919-20 (Bankr. E.D. Mich. 1996) ("Following confirmation of a [C]hapter 11 debtor's plan, a bankruptcy court has a fairly narrow jurisdiction."). Some bankruptcy courts, however, decline to acquiesce to this limited jurisdiction post-confirmation. For example, the bankruptcy court in *Guttman v. Martin (In re Railworks Corp.)*, 325 B.R. 709, 722–24 (Bankr. D. Md. 2005) concluded that the implementation of the payment of unsecured creditors through claims prosecuted by a litigation trustee falls squarely in the realm of limited jurisdiction that a bankruptcy court may hear. *See also Mont. v. Goldin (In re Pegasus Gold Corp.)*, 394 F.3d 1189, 1194 (9th Cir. 2005); *In re Blue Water Automotive Sys., Inc.,* 446 B.R. 808, 812 (Bankr. E.D. Mich. 2011) (holding bankruptcy court could exercise post-confirmation jurisdiction over action by liquidating trustee to recover from third party on breach of contract and estoppel theories).

Furthermore, because the distributions made by liquidating trusts often mirror the procedures and priorities set forth in the Bankruptcy Code and bear substantial similarities to liquidation under chapter 7, to the extent provided under the confirmed chapter 11 plan, they are often administered by the bankruptcy court and practitioners in the same manner as chapter 7 proceedings, regardless of the applicability of the procedures. Pugatch, *supra*, at 64. Ordinarily, a chapter 11 debtor has 120 days from the petition date during which it has the exclusive right to file a plan, and after which any party-in-interest may propose their own

plan of reorganization or liquidation using a liquidating trust. 11 U.S.C.§ 1121(b). This period generally allows the debtor a reasonable amount of time to obtain confirmation of a plan without the threat of a competing plan, and it ensures creditors will not endure unreasonable delay after a debtor files for chapter 11. *In the Matter of Mother Hubbard, Inc.,* 152 B.R. 189, 195 (Bankr. W.D. Mich. 1993). Thus, creditors who want to have a voice in the terms of a liquidating trust created as part of the plan would want to work with the debtor to ensure that a debtor's plan creates a liquidating trust and contains other provisions that protect their interests.

The confirmation of a plan generally requires approval of at least one class of impaired creditors with substantially similar claims to accept the plan (or all classes of creditors and interests), and any party-in-interest may object to confirmation of a plan. *See generally* 11 U.S.C. § 1122, § 1128(b). A class of creditors votes in favor of a plan when "at least two-thirds in amount and more than one-half of in number of allowed claims of such class held by creditors" actually vote in favor of the plan. 11 U.S.C. § 1126(c). For purposes of confirmation, the plan must also satisfy the other requirements listed in 11 U.S.C. § 1129. For instance, under § 1129(a)(7), the proposed plan must satisfy the "best interests of creditors" test which requires that each class of creditors "will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on that date." 11 U.S.C. § 1129(a)(7).

Because creating a chapter 11 liquidating trust requires the confirmation of a plan not typically used in a chapter 7 case, the bankruptcy court must find that the chapter 11 liquidating trust will provide value to creditors that exceeds the expense of drafting and confirming the plan and result in a higher recovery for creditors than a standard chapter 7 liquidation administered by a trustee. Prager, *supra,* at 31-32. If confirmation of a plan creating a liquidating trust will likely fail to meet the "best interests" test and is found to be a time-consuming process, whether it be contested or otherwise, the creditors should consider whether a conversion to chapter 7 is warranted. *Id. at 35.*

Under Section 363 of the Bankruptcy Code, a debtor may couple a "liquidating plan" with a Section

363 sale of substantially all its assets held pursuant to a set of court-sanctioned sale procedures prior to confirmation, but this quick sale may circumvent the procedures and protections (*i.e.*, disclosure, voting, and substantive plan content requirements) of the plan confirmation process and may result in a price lower than the true value of the assets. 11 U.S.C. § 363(b)(1); *See, e.g.*, *In re Lionel Corp.,* 722 F.2d 1063, 1071 (2d Cir. 1983). To mitigate the conflict between larger secured creditors who may favor this quick sale and unsecured creditors who prefer a maximized sale, and to prevent a chapter 7 conversion, the secured creditor may agree to a guaranteed carve-out of its claim to fund plan confirmation and a liquidating trust that guarantees the unsecured creditors the ability to pursue unliquidated litigation claims, including avoidance actions, in exchange for their support for the proposed Section 363 sale. *See, e.g., ACC Bondholder Group v. Adelphia Commc'ns. Corp. (In re Adelphia Commc'ns. Corp.)*, 361 B.R. 337, 342 (S.D.N.Y. 2007); Prager, *supra*, at 33. Alternatively, the plan itself could provide for a Section 363 sale pursuant to § 1123(a)(5) of the Code. 11 U.S.C. § 1123(a)(5).

III. Liquidating Trust and § 1123(b)(3)

11 U.S.C. § 1123(b)(3) provides that a plan may provide for "(A) the settlement or adjustment of any claim or interest belonging to the debtor or to the estate or (B) the retention and enforcement by the debtor, the trustee or a representative of the estate appointed for such purpose, of any such claim or interest." Upon the filing of a bankruptcy petition, 11 U.S.C. § 541(a) creates an estate that includes all legal and equitable interests of the debtor in property as of the petition date. Pursuant to Section 323, the trustee is the representative of the estate and in such capacity, the trustee may sue or be sued. In a chapter 7 or 13 case, a trustee is appointed in accordance with 11 U.S.C. §§ 704 and 1302. In a typical chapter 11 case, except as provided under Section 1104, a debtor in possession is the representative of the debtor's estate during the pendency of such debtor's chapter 11 case pursuant to 11 U.S.C. § 1107, and as such, has the standing to assert causes of action that constitute estate property. "While [S]ections 323, 541 and 1107 establish the statutory authority of the estate trustee to initiate or defend actions on behalf of the estate, 11

U.S.C. § 1123(b)(3) provides statutory authority for the settlement, pursuant to the plan, of any action filed or which could have been filed in respect of a claim that constitutes 'property of the state' or 'property of the Debtor.'" 7 COLLIER ON BANKRUPTCY ¶ 1123.02[3] (16th ed. 2021). Section 1123(b)(3) does not mandate a settlement, but "permits the plan to provide for the retention and enforcement of causes of action that are not settled under the plan, by the debtor, the trustee or a representative of the estate appointed for the purpose of pursuing and enforcing such claims." *Id.*

Then, for purposes of Section 1123(b)(3), is a liquidating trustee an estate representative? The answer is likely yes, the liquidating trustee *can* be a representative under § 1123(B)(3). *In re Texas Petroleum Corp.*, 52 F.3d 1330, 1335 (5th Cir. 1995); *In re Sweetwater*, 884 F.2d 1323, 1327 (10th Cir. 1989). The plan will provide for the "retention and enforcement by the debtor, by the trustee, or by a representative of the estate appointed for such purpose, of any such claim or interest" belonging to the debtor or the estate. 11 U.S.C. §1123 (b)(3)(B). Further, the appointment of the trustee by the key parties (*e.g.*, the chapter 11 debtor and unsecured creditors' committee) must be approved by the bankruptcy court. Some courts have found that to be a representative, "[the] primary concern is whether a successful recovery by the representative would benefit the debtor's estate and particularly the debtor's unsecured creditors." *Texas Petroleum Corp.*, 52 F.3d at 1335 (finding successful recovery by the liquidating trust would benefit debtor's unsecured creditors and Plan appointed liquidating trustee as representative); *Sweetwater*, 884 F.2d at 1327. Thus, the trustee functions to reduce the level of oversight required from the bankruptcy court, and ultimately, the cost of administration. As such, for the purpose of the trust, a liquidating trustee is likely an estate representative under Section 1123(b)(3)(B).

IV. Limitations of the Liquidating Trustee:

The power of a liquidating trustee is not unlimited. The liquidating trustee's powers can be limited by "the plan, the bankruptcy court's confirmation order, or the liquidating trust agreement." Prager, *supra,* at 33. Further, in order to maintain their favorable tax treatment as a liquidating trust under the IRS regulations, the liquidating trust must end "on a fixed date, generally no more than five years from its

creation and, during that time, the liquidating trustee must actively attempt to dispose of the trust's assets and not unduly prolong its existence." *Id.* Often, the liquidating trust's tax returns are filed as a "grantor" trust which does not generate its own tax liabilities, but the expansion of the trustee's powers beyond the normal powers designed to make the trust productive may result in the trust being designated as a taxable trust rather than a grantor trust. *See* Rev. Proc. 94-45, 1994-2 C.B. 684 (applying the more general provisions of Rev. Proc. 82-58 in the context of chapter 11 plans).

The liquidating trustee may bring avoidance actions such as preference and fraudulent conveyance actions under 11 U.S.C. §§ 547 and 548, but the plan must clearly provide that power to avoid the possibility of the bankruptcy court holding avoidance actions not having been transferred to the liquidating trustee. *See, e.g.*, *In re Mako, Inc.,* 985 E.2d 1052, 1055 (10th Cir. 1993) ("We hold that there must be clear evidence of the reservation of the avoidance powers [liquidating trustee] seeks to assert for it to have been appointed under the plan to exercise such powers. Because this evidence is lacking, [the liquidating trustee] is not empowered to bring this litigation.").

Some courts have also decided that liquidating trusts "may press state law fraud claims against a bankrupt corporation's outside counselors and consultants for the benefit of the corporation's creditors" when the trust's "primary purpose" is not only to pursue such litigation. *RHG Liquidating Tr. ex rel. Reliance Grp. Holdings, Inc. v. Deloitte & Touche, LLP*, 17 N.Y.3d 397, 413 (2011). This test ensures that the purpose of the trust is not to circumvent the "the single-entity exemption" of the Securities Litigation Uniform Standards Act of 1998 (SLUSA). *Id.* at 399.

V. What liquidating trust issues should the bankruptcy court retain jurisdiction over, and what should be kicked to other appropriate venues given it is a trust created under state law?

This depends. District courts have "original but not exclusive jurisdiction of all civil proceedings arising, or arising in or related to cases, under title 11." 28 U.S.C. § 1334(b). In *Pacor, Inc. v. Higgins*, the Third Circuit held that "the test for determining whether a civil proceeding is related to bankruptcy is whether the outcome of that proceeding could conceivably have any effect on the estate being administered

in the bankruptcy." 743 F.2d 984, 994 (3d Cir. 1984). Further, "though courts have varied the standard they apply post-confirmation, the essential inquiry appears to be whether there is a close nexus to the bankruptcy plan or proceeding sufficient to uphold bankruptcy court jurisdiction over the matter." *Resorts*, 372 F.3d at 167. However, this jurisdiction "becomes very limited following a confirmation of a plan of reorganization." (Pugatch, *supra*, at 66). Post-confirmation, the bankruptcy court's "role is limited to matters involving the execution, implementation, or interpretation of the plan's provisions, and to disputes requiring the application of bankruptcy law. *Zahn Assocs., Inc. v. Leeds Bldg. Prods, Inc. (In re Leeds Bldg. Prods., Inc.)*, 160 B.R. 689, 691 (Bankr. N.D. Ga. 1993) (finding that the "dispute [arose] out of a contract, and by its own terms the obligations are subject to the laws of the State of Georgia"). Those who wish to use a liquidating trust "should be prepared for the likely scenario that they will find themselves in a non-bankruptcy forum with respect to the liquidation of the former bankruptcy estate's litigation claims and disputes arising under the trust." *Id.*