By Joseph A. Shifer[1]

The Day After: Navigating Post-Chapter 11 Trusts

Joseph A. Shifer
Kramer Levin Naftalis & Frankel LLP
New York

Joseph Shifer is special counsel with Kramer Levin Naftalis & Frankel LLP in New York.

An increasingly common feature of the chapter 11 landscape is the use of a post-bankruptcy trust to deliver value to creditors. Trusts offer an efficient vehicle to provide a recovery to creditors if the value to be distributed is not immediately accessible upon the effectiveness of a plan and will instead be monetized over time.

In those cases, leaving the debtor in control of distributions to creditors is impossible because the monetization process requires oversight by a fiduciary other than the debtor. Delegating the monetization of illiquid assets to a trust acting for the benefit of creditors ensures that a fiduciary will act in the best interests of the creditors and permits the bankruptcy case to be closed or, even if formally kept open, to be run more efficiently as a result of a decrease in the number of estate professionals, reduced reporting requirements and potential cessation of payment of U.S. Trustee fees.

This article provides an overview of certain basic considerations in forming a post-bankruptcy trust. Although the aspects of establishing a trust addressed herein are complex, the purpose of this article is to familiarize the practitioner with the issues rather than provide exhaustive discussion of the details.

Corporate Form

An important initial consideration is the legal form of the trust. In most jurisdictions, a common law trust can be formed through the execution of a trust agreement or similar legal document that identifies the trustor, trustee and beneficiary of the trust, and passes legal title of the assets to be administered by the trustee on the beneficiary's behalf. Use of a common law trust can be challenging due to a lack of uniform rules regarding the liability of the trustee and the beneficiaries to third parties.

By contrast, use of a Delaware statutory trust provides the debtor and its creditors with a well-developed set of rules that governs the trust and the liabilities of the parties involved. Forming a Delaware statutory trust is straightforward and is created by filing a certificate of formation executed by the trustee(s) with the Delaware Secretary of State and executing a governing instrument, commonly styled as a "trust agreement."

Pursuant to § 3803(a) of the Delaware Trust Statute, trust beneficiaries are "entitled to the same limitation of personal liability extended to stockholders of private corporations," unless the trust agreement provides otherwise.[2] Thus, in order for a third party to assert claims against the beneficiaries of a Delaware statutory trust, it must first pierce the corporate veil in the same manner as would be needed to assert a claim against the shareholder of a corporation.

In addition, § 3803(b) of the Delaware Trust Statute provides that the trustee — when acting in its capacity as trustee — "shall not be personally liable to any person other than the statutory trust or a beneficial owner for an act, omission or obligation of the statutory trust." Accordingly, the trustee of a Delaware statutory trust enjoys broad immunity from potential actions by third parties while acting as trustee. In instances where the assets to be administered by the trust include litigation claims against the third parties, providing a trustee with such immunity might be necessary to shield the trustee from liability attendant with pursuing the litigation.

Further, the trustee might be protected from derivative suits by beneficiaries. Under § 3816 of the Delaware Trust Statute, trust beneficiaries retain the ability to bring derivative actions, but the trust agreement may specify the requisite beneficial ownership threshold for bringing such suits. The trust agreement can also address other critical aspects of the trust, including the duration and termination of the trust and the procedures for effecting distributions to beneficiaries.

At least one trustee of a Delaware statutory trust must have a place of business in Delaware (or in the case of a natural person, be a resident of Delaware), commonly referred to as a "Delaware trustee."[3] This is usually achieved by the retention of a Delaware-based financial institution that provides trust services. The Delaware trustee's responsibilities are strictly defined by the trust agreement and typically do not include management responsibilities.

Corporate Governance

Governance of a post-bankruptcy trust can be flexible and tailored to a case's circumstanc-

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2 *See* 12 Del. C. § 3801-3829, *et seq.*
3 12 Del. C. § 3807.

es. Similar to the appointment of an official committee of unsecured creditors, there may be disparate creditor groups whose interests must be represented in the management of the trust. There are several models that can be used to achieve representative governance. One possibility is that rather than having a single trustee appointed to act on behalf of the trust, management of the trust can be vested in a board of co-equal trustees. The trust agreement can provide for the trustees' decision-making protocol and prescribe what actions require a simple majority, supermajority or unanimity among the trustees.

Section 3806(b)(7) of the Delaware Trust Statute allows a trust agreement to provide for the employment of officers, managers and other employees, and § 3803(c) provides them with a limitation of liability. In the event monetization of the trust's assets requires special expertise, a professional trust manager with the requisite capabilities can be appointed. The trust manager need not have responsibility for the governance of the trust, but would conduct the monetization process under the supervision of the trustee or trustees.

An alternative to appointing multiple trustees is to designate a single trustee and appoint an oversight board that represents the various creditors' groups and serves as a check against the trustee on certain key issues, such as distributions to beneficiaries, replacement of the trustee and termination of the trust. The trustee retains full responsibility for the trust's governance, but requires oversight board approval for key issues and has a general duty to consult with the oversight board with respect to the affairs of the trust. A trust agreement can provide those oversight board members with the ability to supervise a trustee without the board members assuming fiduciary duties.[4]

Taxation of the Trust

A key consideration in establishing a post-bankruptcy trust is to ensure that the trust is structured in a manner that is maximally tax efficient for all parties. Taxation of trust assets in practice raises many complex issues, and this summary is intended only to familiarize practitioners with some of the issues. There are numerous factors that can implicate different and complicated tax rules, and tax considerations should be thoroughly evaluated by qualified professionals in connection with the establishment of any post-chapter 11 trust.

Generally speaking, all income is treated as taxable gross income unless otherwise subject to an exemption. Efficient tax treatment commonly entails the avoidance of double taxation payment of taxes by the trust on the assets it receives and holds, and payment of taxes by the beneficiaries on trust distributions. The tax treatment of the trust and its distributions is dependent, among other things, on the specifics of the assets transferred to the trust and claims of its beneficiaries against the debtor.

In a scenario where the consideration transferred to a trust consists primarily of litigation claims previously belonging to the debtor, if the trust is treated as a qualified settlement fund (QSF) for U.S. federal income tax purposes, the trust should not recognize income when it receives the transferred litigation. However, any income generated from the litigations will be subject to entity-level taxation, similar to how a corporation is subject to tax on its income.[5] If the creditors seeking a recovery from a trust consist of tort claimants against a debtor, tax professionals are generally comfortable that distributions from the QSF under similar circumstances can be excluded from gross income under a specific statutory exclusion that applies to compensation for injuries or sickness.[6] Accordingly, under these circumstances, the creditors' recovery from the trust will be subject to a single layer of taxation, and QSF trusts are commonly used in mass tort bankruptcies.

However, under the same scenario, if the creditors receiving a distribution from the trust are ineligible for an exemption on distributions from a QSF, their recoveries may be subject to a second layer of taxation when they receive their distributions. Trusts that are created for the benefit of general trade creditors or debtholders are generally ineligible for treatment as a QSF, and such trusts are usually treated as "liquidating trusts" taxable as grantor trusts for U.S. federal income tax purposes.[7] IRS guidance requires transfers to a liquidating trust to be treated as taxable exchanges between the creditors and the debtor, followed by a contribution of the settlement proceeds to the trust.

As such, the beneficiaries will recognize a gain or loss on the difference between the value of settlement consideration at the time of contribution and the tax basis in their claims against the debtor. However, since the trust is taxable as a grantor trust, the beneficiaries are taxed directly and entity-level taxation is avoided.

A complication arises if not all claims that were filed against the debtor in the bankruptcy are allowed as of a chapter 11 plan's effective date (commonly referred to as "disputed claims"), and therefore certain beneficiaries have yet to be identified when the trust begins to make distributions. The disputed claims cannot receive distributions until the post-bankruptcy trust conducts a claims-reconciliation process through which the asserted claims might be allowed in full, disallowed in full or allowed in a reduced amount. Distributions that would otherwise go to the holders of such disputed claims must be placed into a disputed claims reserve (DCR) for eventual distribution if the claims are allowed, or distributed to the other beneficiaries who hold allowed claims if the claims are ultimately disallowed.

Under certain circumstances, the Treasury Regulations permit a pool of assets subject to such conflicting claims of ownership to be treated as a disputed ownership fund, which is taxed in a manner similar to a QSF and thus presents a risk for multiple layers of taxation (*i.e.*, taxation on the assets of the trust as well as taxation on distributions).[8] Careful tax planning is required to ensure the proper and efficient tax treatment of a post-bankruptcy trust.

4 *See* 12 Del. C. § 3804.

5 *See* Treas. Reg. § 1.468B-2.
6 *See* 26 U.S.C. § 104.
7 *See* Treas. Reg. § 1.468B-1(a), (c)(2), (g)(3).
8 *See* Treas. Reg. § 1.468B-9.

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Potential Securities Issues

As previously discussed, a post-bankruptcy trust is often used where the source of creditors' recoveries is illiquid. Accordingly, although a trust may often start with an amount of cash ready for immediate distribution to its beneficiaries, the main corpus of the trust will only be available for distribution over time as the illiquid assets are monetized. The trust may issue beneficial ownership interests to its beneficiaries entitling them to these distributions.

The Securities Act of 1933 (1933 Act) provides for a broad definition of the term "security," and these trusts' interests may be regarded as securities.[9] This potentially requires registration of interests in the trust with the U.S. Securities and Exchange Commission (SEC) under the 1933 Act.[10] Registration of trust interests is usually not a viable option, as the cost of filing a registration statement and complying with other applicable securities law requirements, including public reporting under the Securities Exchange Act of 1934, over the life of the trust, might be costly and time-consuming.

Section 1145 of the Bankruptcy Code generally provides an exemption from registration for securities issued under a chapter 11 plan by a "debtor" or a "successor of the debtor" in exchange for a bankruptcy claim.[11] However, a § 1145 exemption might not be applicable if a chapter 11 case is resolved without plan confirmation (such as a sale under § 363 of the Bankruptcy Code) or where the trust is not deemed to be a "successor of the debtor," perhaps because the debtor has reorganized and is continuing as a going-concern business.

If § 1145 is unavailable, the trust can issue nontransferable (other than transfers under applicable law, such as laws of descent) and noncertificated interests to its beneficiaries. The SEC staff has issued a series of no-action letters in which it agreed not to recommend enforcement action where interests of this type are issued by a liquidating trust without 1933 Act registration.[12]

Nontransferable interests in the trust will likely be unattractive to institutional claimholders, who may wish to monetize their trust interests rather than await distributions over time. Subject to careful compliance with the securities laws, a post-bankruptcy trust might be able to issue transferable units to these investors pursuant to applicable private placement exemptions available under the 1933 Act. In circumstances where a trust's beneficiaries include both sophisticated investors that qualify for a private-placement exemption and other claimholders that do not, the trust may both issue transferable interests to qualifying holders and record on its books nontransferable entitlements to distributions for the benefit of holders that are ineligible to receive securities without registration.

Conclusion

The use of post-bankruptcy trusts is an essential tool for effecting distributions to creditors when distributions are not immediately possible under a chapter 11 plan. Use of a Delaware statutory trust provides maximum flexibility in terms of governance and operation of the trust, while also providing limitation on liability to the trust's fiduciaries and other agents.

Due to the basic nature of a trust — distribution of assets that are monetized over time — there can be complex issues surrounding the taxation of a trust and its beneficiaries, as well as securities law issues relating to the beneficial ownership interests it provides to creditors. In cases in which a liquidating trust is the vehicle of choice for monetizing and distributing assets of the bankruptcy estate to creditors, practitioners are advised to promptly identity and resolve the governance, tax and securities law issues implicated by this structure to ensure that creditors receive their recoveries in an orderly and efficient manner. abi

9 *See* 15 U.S.C. § 77(b).
10 Other securities issues beyond the applicability of the 1933 Act may be implicated for interests issued by a post-bankruptcy trust, such as the applicability of state blue sky laws or the Investment Company Act of 1940, but they are not addressed in this article.
11 *See* 11 U.S.C. § 1145(a).
12 *See, e.g., Guerdon Real Est. Tr.*, 1989 WL 245863 (S.E.C. No-Action Letter March 31, 1989). The SEC has issued several no-action letters on this topic, and it may be advisable to seek such guidance from the SEC prior to the establishment of a post-bankruptcy trust.