



AMERICAN
BANKRUPTCY
INSTITUTE

2018 Southwest Bankruptcy Conference

Post-Confirmation Liquidating and Litigation Trusts

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CONCURRENT SESSION

2018

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ABI Southwest Conference
September 2018

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Panelists

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What is a liquidating or litigation trust?

- What is it? A legal entity created under a court approved bankruptcy plan, funded with assets from the debtor estate, and intended to act in the best interests of a specified group of beneficiaries—formed under Section 1123(b)(3)(B)
- While trusts are usually state law trusts, state law LLCs can be used and other mechanisms can be explored. The name varies depending on the situation, i.e. litigation trust, liquidation trust, LLC name, etc.
- Operative documents -- the plan, disclosure statement, trust agreement (or other operative document), confirmation order and if needed other transfer documents
- Sometimes a trust is used as part of a structured dismissal or under a settlement

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- Sometimes a trust is used where all of the operating assets of the debtor have been sold pre-confirmation and the remaining assets and litigation are put into a trust
- Following the sale of the business in bankruptcy, there are four basic options:
 - Convert the case and have chapter 7 trustee liquidate the assets and lawsuits
 - Confirm a plan providing for the creation of a liquidating trust
 - Allow the debtor in possession to continue to discharge its duties and administer the chapter 11 case
 - Dismiss the case without a resolution of the claims and assets returning to the debtor entity

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- Sometimes the reorganized entity is allowed to continue its operations and exit from bankruptcy while certain assets, including litigation, and certain liabilities are put into a trust to be liquidated and distributed
- Trusts often fill the role that in the past would have been performed by the debtor in possession. Trusts are often tasked with:
 - Asset disposition
 - Claims reconciliation and processing
 - Avoidance action litigation
 - Investigation and prosecution of other litigation
 - Distribution of proceeds

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- Who might be the beneficiaries of a trust or multiple trusts?
 - Unsecured creditors (this is the most common use)
 - Selected groups of other creditors such as bondholders, mass tort claimants, claimants with possible future claims, environmental claimants
 - Creditors of only one member of a corporate family
 - Priority creditors who agree to be paid under the trust rather than under the plan
- Liquidating trusts are usually structured as grantor trusts for tax purposes—**seek professional tax advice** as you contemplate and structure the trust

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- There have been other creative and innovative uses of trust “concepts” in cases
 - LLCs were used in *Mortgages Ltd.* case– trust was used for litigation but LLCs were used for liquidation of about 60 real property interests
 - Multiple trusts were used in *Tronox* case– the company was allowed to exit bankruptcy and continue its operations while a litigation trust used for the significant fraudulent transfer litigation with proceeds to be disbursed to other trusts. Several different Environmental Response Trusts were used to take title to and clean up the contaminated properties with multi federal and state agencies as beneficiaries. A separate Torts Claims Trust was also set up
 - *MagCorp* case– chapter 7 trustee kept case open for 15 years and used litigation funding to fund recovery for creditors in the event litigation was not successful
 - Mass tort claims, future claimants, asbestos claimants, sexual abuse or personal injury cases where long term litigation and resolution are needed

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- In sum, benefits of a trust mechanism can be:
 - Unsecured creditors (or beneficiaries) can control the process, no more debtor involvement
 - Administrative costs of bankruptcy can be reduced/saved by confirming plan quickly and eliminating the debtor’s professionals and advisers from the litigation and liquidation
 - Reorganized debtor is allowed to go on with its business without administrative costs of a bankruptcy saving jobs and restructuring the debt while funding a trust to administer, liquidate and litigate the claims
 - Allows access by the Trust to documents and records and employees of the reorganized debtor without additional operating costs
 - Allows creative use of trusts or LLCs for a variety of purposes and problems
 - Provides for retention of court jurisdiction for certain purposes without the full supervision, delay and cost of a chapter 11 or 7

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Basic Trust Structure

- Selection of Trustee
 - Generally done by unsecured creditors' committee since the unsecured creditors are the primary beneficiaries of the trust
 - Debtor may be granted consent rights regarding the selection of the trustee
 - Considerations—
 - Experience (generally with bankruptcy and/or regarding case)
 - Expense (negotiate hourly fee, contingent fee, flat monthly fee or hybrid)
 - Independence and lack of conflicts
 - Geographical location
 - Include qualifications in the disclosure statement along with a disclosure of compensation
 - Include appointment in confirmation order

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- Powers and duties of the Trustee
 - Powers to be stated in plan and trust agreement
 - Collect and administer the remaining assets of the debtor's estate
 - Make distributions to holders of allowed claims
 - Pursue estate causes of action including avoidance actions and third party litigation such as director and officer litigation and actions against prepetition professionals
 - Retain trust professionals
 - Conduct claims reconciliation process
 - Abandon assets
 - Investigate trust assets including right to seek examinations pursuant to FRBP 2004
 - Pursue causes of action including right to commence, prosecute, compromise, settle, release, abandon or resolve

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- Scope of Assets being transferred
 - What claims and causes of actions are being transferred to trust versus released or waived
 - Avoidance actions— Section 1123(b)(3)
 - Claims
 - Third party actions
 - Other assets to be transferred to the trust, cash, accounts not collected, real property, refunds, leases, FF&E, computers, licenses, records, etc.

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- Liquidity for the Trust
 - Establish budget and projections for trust operations and for the trust's administrative costs—trustee's fees, real estate taxes, D&O insurance, records preservation, professional fees, etc.
 - It is essential that the trust have sufficient funds or sources of funds on the effective date to retain professionals and begin in liquidating assets
 - Will there be cash transferred to the trust on the effective date from on-going operations or settlement or other source?
 - Will assets be transferred to the trust that when liquidated will help fund the trust?
 - Explore options for third party financing of litigation

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- Trust oversight committee or board
 - Sometimes a board or committee is appointed to provide advice and guidance to the trustee and oversight over the activities of the trustee
 - Usually comprised of unsecured creditors (or other beneficiaries of the trust)
 - Must accurately define the role of the board and scope of authority
 - Consider if board should be able to veto certain decisions of trustee or just advise
 - Retain jurisdiction before the court to resolve disputes if there is a disagreement between trustee and board

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- Other issues to address in the plan and disclosure statement:
 - Include qualifications of trustee and board members in disclosure statement
 - Include appointment of trustee and board members in confirmation order
 - Include conflict of interest provisions in plan and trust agreement for recusal when actual or potential conflict arises
 - Provide for access to, retention of documents and employees of reorganized debtors
 - Transfer of privileges—trustee must be able to invoke or assert or waive protection of various privileges (attorney-client and attorney work product) of the debtor
 - Consider whether the trustee should be able to invoke, assert or waive protections of various privileges of the creditors committee
 - Provide standard for removal of trustee and board members and for replacement process

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Trust Agreement

- Filed as part of plan, attached to disclosure statement if possible or filed and served as a supplement before voting takes place
- Agreement, along with trustee and board members, to be approved by the bankruptcy court in the confirmation order
- Agreement should set forth the terms of the trust, including:
 - Scope of the trustee's powers and duties
 - The trustee's fee structure (or can be done in separate agreement)
 - Scope of the board's duties and oversight
 - The replacement or removal of the trustee and board members
 - Reporting obligations and communications with beneficiaries
 - Establishing reserves and budget
 - Post-confirmation settlement authority
 - Appropriate tax treatment of the trust
 - Trust term, extension of trust term by court and closing of the chapter 11 case
 - Indemnification and exculpation provisions

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Standing to Bring Suits and Claims

- Include language in plan, confirmation order and in the trust agreement about standing to bring claims
- Section 1123(b)(3) authorizes a plan:
 - To settle or adjust any claim or interest belonging to the debtor or the estate
 - To provide for the trustee's retention and enforcement of any such claim or interest
- Some courts interpret Section 1123(b)(3) to require that the confirmed plan provides for the "specific and unequivocal" preservation of litigation claims to have standing to assert the claim. *See, e.g., Dynasty Oil & Gas, LLC v Citizens Bank (In re United Operating, LLC)*, 540 F.3d 351, 355 (5th Cir. 2008); *Harstad v First Am. Bank*, 39 F.3d 898, 902-3 (8th Cir. 1994).

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- However, some courts only require general type and categories. See *Fleet Nat'l Bank v. Gray (In re Bankvest Capital Corp.*, 375 F.3d 51 (1st Cir. 2004)(general reservation indicating type and category would be sufficient); *Alary Corp. v. Sims (In re Associated Vintage Group Inc.)*, 283 B.R. 549 (9th Cir. BAP 2002).
- Beware—failure to identify claims properly could result in dismissal of claims for lack of standing or failure to state a claim upon which relief can be granted.

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Indemnification and Exculpation

- To encourage qualified parties to become trustees and board members, trust agreements contain provisions protecting trustees and board members:
 - Indemnification provisions authorize the trustee and board members to assert claims against the trust for reimbursement of losses incurred
 - Exculpation provisions provide that third parties may not assert claims against the trustee or board member
 - Indemnification and exculpation provisions contain exceptions for fraud, gross negligence or willful misconduct
 - Obtain D&O insurance for the trustee and board

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Potential Liability of Trustee and Board Members

- Bankruptcy Code does not establish a specific standard for the conduct of post-confirmation liquidating trustees or board members
- State trust law may provide the applicable standard of liability in most instances based on analogy of corporate law. Trustee (and board members) are fiduciaries and typically are alleged to have
 - Duty of care, loyalty, and good faith
- “business judgment rule” v. “reasonably prudent person” standards often discussed by court in approving action
- Trustee and board members may be entitled to “**quasi-judicial immunity**” rulings in favor of trustee and board members. *Harris v. Wittman (In re Harris)*, 590 F.3d 730 (9th Cir. 2009)
- As well, in some courts the protection of the *Barton* Doctrine requires the permission of the appointing bankruptcy court before suit can be brought. *Beck v. Fort James Corp. (In re Crown Vantage, Inc.)*, 421 F.3d 963 (9th Cir. 2005)

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Court oversight of liquidating trusts

- Court must determine that appointment of the trustee is consistent with public policy and in the best interests of creditors and equity security holders. See Section 1129(a)(5)(A)
- Bankruptcy court will generally retain jurisdiction over all matters related to the trust’s administration and interpretation of plan or confirmation order
- Precise extent of court involvement in the decision-making processes of the trust will differ from case to case
- It may be beneficial to provide the trustee with the right but not the duty to seek authority from the bankruptcy court for taking or refraining to take such actions

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- Filing of quarterly status reports—and payment of UST fees – is generally required until the case is actually closed.
- Court could retain jurisdiction over disputes between trustee and board or for replacement or removal of trustee or board member
- Except to the extent provided by the trust agreement, court approval is not generally required for:
 - Retention of trust professionals
 - Sales of trust assets– i.e. higher and better bid sale process
 - Settlement of claims
 - Settlement of litigation
 - Distribution of trust proceeds

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- Acting pursuant to a bankruptcy court order may provide the trustee and board members with insulation from liability– *Harris v. Wittman (In re Harris)*, 590 F.3d 730 (9th Cir. 2009)
- Some trustees and professionals argue that the administrative burdens associated with seeking court approval for actions causes unacceptable cost and delay to the administration of the trust
- Sometimes seeking court authority provides a tangible benefit to the trust administration, even if it may be more cumbersome to do so
- Courts generally retain jurisdiction over claim-related litigation and ancillary litigation (e.g., avoidance actions, D&O litigation, etc)
- Court oversight should be viewed as a resource rather than a burden

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- Bankruptcy Court jurisdiction over post-confirmation matters, including the administration of trusts, is more limited than pre-confirmation jurisdiction
- 28 U.S.C. § 1334 provides three basic types of jurisdiction:
 - “Arising in”—matters that only occur in bankruptcy cases
 - “Arising under”—matters relating to rights created by the Bankruptcy Code
 - “Related to” – matters that potentially impact the administration of a bankruptcy case
- Confirmation order and plan may provide for retention of jurisdiction, but cannot create jurisdiction where not conferred by statute

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- Non-core matters must generally have a “close nexus” to implementation of the confirmed plan. *See In re DPH Holdings Corp.*, 448 Fed. Appx. 134, 137 (2d Cir. 2011); *In re Pegasus Gold Corp.*, 394 F.3d 1189 (9th Cir. 2005)
- However, some courts interpret post-confirmation jurisdiction over “related to” causes of action asserted by the trustee broadly and find no difference in jurisdiction whether the action is brought pre-confirmation or post-confirmation. *See Boston Reg’l Med. Ctr., Inc. v. Reynolds (In re Boston Reg’l Med. Ctr., Inc.)*, 410 F.3d 100 (1st Cir. 2005)
- Is there an applicable forum selection clause or arbitration clause? Courts have held debtors bound to pre-petition arbitration clauses unless enforcement conflicts with policies under the Bankruptcy Code

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- There is a split of authority over whether a litigation trust can bring *direct* claims belonging to creditors along with the *derivative* claims brought by the trustee— check your circuit court decisions
- Ninth Circuit held bankruptcy trustee lacked standing to assert creditor’s direct claims – even though creditors assigned their claims to trustee and bankruptcy court blessed arrangement in advance. Court emphasized that trustee’s pursuit of claims would only benefit assigning creditors. *Williams v. California First Bank*, 859 F.2d 664 (9th Cir. 1988)
- Seventh Circuit held that post-confirmation trustee could represent creditors in their direct claims against third parties – even though distribution would only be made to assigning creditors, not all creditors. *Grede v. Bank of New York Mellon*, 598 F.3d 899 (7th Cir. 2010); *Semi-Tech Litigation, LLC v. Bankers Trust Co.*, 272 F. Supp. 2d 319 (S.D.N.Y. 2003)(Chapter 11 plan could assert claims assigned by creditors, rejecting *Williams*); *In Re CBI Holding Company, Inc.*, 529 F.3d 432 (2nd Cir. 2008)(reaffirmed and expanded *Semi-Tech Litigation*)

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- In negotiating plan, consider whether to assign creditor direct claims to litigation trust. If so, you need to wrap into the plan and confirmation process.
- On the other hand, consider whether it is better and less of a risk in your circuit to cooperate with a firm to bring a class action to make sure direct claims of creditors are brought, to share documents and experts, to avoid race to court house against common defendants and insurance policies, to bring maximum pressure against defendants, and to coordinate the distribution of recoveries
- As plan is being negotiated and drafted, consider and address these issues and avoid common traps that could blow up your claims later:
 - Identify targets and major legal and factual issues (for example, *in pari delicto*)
 - Advise on threshold procedural issues such as forum and choice of law
 - Advise on limitations and laches to avoid any risk of untimely claims
 - Identify claims that are not assignable and/or where assignment may eviscerate claims
 - Collect and preserve relevant evidence to avoid any spoliation allegations
 - Take advantage of Rule 2004 examinations to gather evidence for claims

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How can a trust be funded

- As discussed previously the trust can be funded with cash, accounts to be collected, equipment, computers and software licenses, real property, causes of action and any other remaining assets that can be found
- However, there needs to be sufficient liquidity to fund the administrative expenses of the trust and the professionals and expert fees who are needed in order to recover the proceeds from lawsuits
- Obtaining third party litigation financing to provide funds to the trust or to the contingent fee counsel for the trust to pursue the litigation is a growing area and should be explored
- There are several funders in the industry, one of the largest of which is Bentham IMF

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How are companies using litigation finance

- Value of litigation and arbitration claims is used to obtain financing
- Non-recourse
- Used by companies to
 - Fund legal fees or expenses of litigation in single cases
 - Finance portfolios of litigation
 - Transfer or share risk in matters
 - Monetize litigation assets at beginning of a case, or after judgment or appeal
 - Secure debt facilities
 - Finance, sell, or collect uncollected judgments
 - Secure litigation-related insurance and risk solutions
 - Trace assets and enforce judgments against litigation debtors
 - Pay administrative expenses and priority claims to allow for confirmation
 - Fund a distribution to creditors

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What does the Funder look for

- Strong merits
- Strong case for damages – strong preference for cash damages
- Stage of case or cases
- Single case binary risk of loss or diversified portfolio
- Ratio between needed investment and realistic resolution value
- Anticipated duration
- Enforceability of judgment
- Track record of counsel
- Economic terms are bespoke, reflecting combination of risks

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How are trusts using litigation financing

- Provides capital to litigation trusts with valuable litigation claims
- Well-suited to litigation trusts with multiple matters of varying levels of risk and duration
- Capital can be used for legal fees, litigation expenses, trust expenses or distributions to creditors
- Funder, not creditors, takes on litigation risk and risk that trust does not produce recoveries
- Pricing can be negotiated by portfolio, tied to recoveries
- Benefits
 - Obviate need for the bankruptcy estate to seed the trust
 - Reduce pressure to agree to releases during plan process to seed the trust
 - Increase upfront cash recoveries for creditors upon confirmation
 - Accelerated and more efficient recoveries for creditors and estate beneficiaries
 - Estate capital can be used to fund administrative expenses

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Funder Relationship

- No interference with lawyer/client relationship or obligations
 - No control over litigation strategy or settlement decisions
- Consideration of confidential and privileged information
 - Case law confirming work product protection applies to funder communications and documents
 - Reputable funders are vigilant in managing diligence to avoid risking waiver of protected communications
- Reporting requirements for investments
 - Regular reporting of significant case developments
 - No decision-making authority
- Investment process:
 - NDA
 - Initial case review
 - Due diligence
 - Ethical compliance
 - Investment approval
 - Negotiation of definitive documents

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Case study: MagCorp liquidation

- Magnesium Corp of America (“MagCorp”), an operating subsidiary of Renco, filed for bankruptcy in 2001, eventually converting to a Chapter 7
- In 2003, the MagCorp chapter 7 trustee initiated an adversary action against Renco for fraudulent transfer, fraudulent conveyance, breach of fiduciary duty and unjust enrichment, resulting in a \$213 million judgment after trial against Renco in 2015
- In 2016, with \$670,000 of cash left, the chapter 7 trustee executed a **363 sale of a right to MagCorp’s litigation proceeds** if the judgment was sustained on appeal and collected
- Public auction generated \$26.2 million for MagCorp on a *non-recourse* basis
 - If the case had to be retried or lost on appeal, guaranteed recovery for creditors and war chest for further litigation
 - If case won, litigation funder would receive \$50 million plus interest
- Bankruptcy court approved transaction as reasonable and in the best interest of creditors and the trustee received the \$26.2 million
- MagCorp’s judgment was ultimately affirmed and judgment was collected in late 2017—Funder got \$50 million plus interest (it’s original \$26.2 million investment plus another \$25 million) and the trustee and his contingent fee counsel got the rest

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Questions and Answers

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