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Bankruptcy Corner

Utilizing Delaware Statutory Trusts as Chapter 11 Liquidating Trusts

By Vincent C. Thomas and Justin P. Duda

Introduction

Every year, thousands of companies seek protection under chapter 11 (“Chapter 11”) of Title 11 of the U.S. Code (the “Bankruptcy Code”) in the U.S. Bankruptcy Courts in New York, Delaware, Texas, and other jurisdictions around the country (such companies, the “Debtors”). While some of these Debtors might seek to utilize Chapter 11 to effect a restructuring of their operations, the majority of Debtors simply cannot service their secured debt facilities and are seeking predominantly to right-size their balance sheets. Other Debtors file for Chapter 11 protection in the midst or on the eve of overwhelming litigation—often related to asbestos, toxic torts, products liability, or environmental contamination. Regardless of the impetus for filing, Chapter 11 provides a centralized, efficient process for these Debtors to both determine the scope of their liabilities and maximize the value of their assets for the benefit of their stakeholders.

Part of the Chapter 11 process for many Debtors—whether following a sale of all or substantially all of their assets in a Bankruptcy Court-supervised auction or in connection with a global settlement among various parties in interest—is the proposal, solicitation, and confirmation of a plan of reorganization or liquidation (a “Plan”) that provides for, among other things, an orderly distribution of the Debtors’ assets. While some Plans contemplate that the Debtors themselves will continue in existence to determine the scope of their liabilities, liquidate their assets, and distribute the proceeds to their various stakeholders, other Plans often provide for the creation of a trust (a “Liquidating Trust”) to handle such matters, with the various creditors of the Debtors as the beneficiaries. Whether or not the relevant Chapter 11 case was administered in the U.S. Bankruptcy Court for the District of Delaware, Plans that contemplate a Liquidating Trust may, and often do, utilize a Delaware Statutory Trust in connection with their implementation. This column describes Delaware Statutory Trusts in general, briefly explains some tax and securities implications of such trusts, and provides some practical drafting tips.

Delaware Statutory Trusts Generally

Generally, a Delaware Statutory Trust is a trust entity formed pursuant to Chapter 38 (“*Chapter 38*”) of Title 12 of the Delaware Code (“*Title 12*”) and governed by the applicable governing documents (collectively, the “*Trust Documents*”), which, in the case of a Liquidating Trust formed in connection with a Chapter 11 case, often include the Plan, the order of the Bankruptcy Court confirming the Plan (the “*Confirmation Order*”), a certificate of trust in compliance with Section 3810 of Chapter 38 (a “*Certificate of Trust*”), and a trust agreement, which may be accompanied by related trust distribution procedures (collectively, the “*Trust Agreement*”). In addition to Chapter 38, except to the extent set forth in the relevant Trust Documents, the other provisions of Delaware statutory law applicable to common law trusts, including Chapters 33 and 35 of Title 12 (collectively, with Chapter 38 and Delaware common law regarding trusts, “*Delaware Trust Law*”), will be applicable to a Delaware Statutory Trust.¹

Two fundamental (and interrelated) concepts of Delaware Trust Law—applicable to both Delaware Statutory Trusts and Delaware common law trusts—are the primacy of the settlor’s intent when creating a trust and the settlor’s contractual freedom to reflect this intent in the governing documents and administration of the trust.² Specifically, with regard to Delaware Statutory Trusts, Section 3825(b) of Chapter 38 provides that “[i]t is the policy of this subchapter to give maximum effect to the principle of freedom of contract and to the enforceability of governing instruments.”³ In the case of a Liquidating Trust formed pursuant to a confirmed Plan, which Plan effectively reflects a settlement among the various parties in interest, there can be considered multiple settlors of the trust (including, without limitation, the Debtors, the Official Committee of Unsecured Creditors (the “*Creditors’ Committee*”), the relevant secured lenders, the Debtors’ insurers, *et al.*), and, in the event of an ambiguity in the Trust Agreement, the intent of all such parties must be considered in interpreting such documents.

The Creation and Administration of a Delaware Statutory Trust as a Liquidating Trust

To create a Delaware Statutory Trust to be utilized as a Liquidating Trust, there must be filed with the Secretary of State of the State of Delaware a Certificate of Trust, which sets forth (i) the name of the Liquidating Trust;

(ii) the name and address in the State of Delaware of at least one trustee which, if an individual, shall be a person who is a resident of Delaware or, if not an individual, has its principal place of business in Delaware (such trustee, the “*Delaware Trustee*”)⁴; (iii) a date of effectiveness, if the certificate of trust is not effective upon filing; and (iv) any other information the trustees determine to include.⁵

While the trustee most commonly handles the administrative duties in connection with a trust under Delaware Trust Law, with regard to Delaware Statutory Trusts (and Delaware common law trusts), there is a long history of having persons in addition to trustees administer or monitor a Delaware Statutory Trust or represent the interests of one or more classes of a trust’s beneficiaries.⁶ Similarly, Delaware Trust Law provides that if a trustee of a Delaware Statutory Trust—notably including the Delaware Trustee—is a directed trustee with regard to certain actions, including without limitation investment and distribution decisions, then such directed trustee will not be liable for following such direction in the absence of willful misconduct.⁷

Depending on the needs of a particular Debtor and the terms of its Plan, a Liquidating Trust may have a number of fiduciaries, including an administering trustee, a Delaware Trustee, a trust protector or committee (which may be the successor of the Creditors’ Committee) with regard to one or more classes of beneficiaries, an investment adviser, and a distribution adviser, among others. With its freedom of contract principles, Delaware Trust Law provides a broad ability to define and limit the scope of the duties of each of the persons engaged in the administration or monitoring of a Delaware Statutory Trust.⁸ This feature may be exploited, for example, by Trust Documents governing a Liquidating Trust set up in connection with a confirmed Plan that uses a channeling injunction under Section 524(g) of the Bankruptcy Code to channel asbestos-related liabilities to the Liquidating Trust. Such Trust Documents typically will provide that the general administration of the Liquidating Trust will be performed by the trustee, and that a committee or certain persons will monitor such performance and have consent and consultation rights to be utilized in favor of various classes of beneficiaries of the Liquidating Trust (*i.e.*, personal injury claimants vs. property damage claimants, or current claimants vs. future claimants).

In a Liquidating Trust context, the Trust Documents often will limit the Delaware Trustee’s scope of duties solely to the filing of the Certificate of Trust and, when appropriate, the certificate cancelling the Liquidating Trust,⁹ and the receipt of service of process on the Liquidating Trust. Notwithstanding this limited scope of duties, in

addition to being statutorily mandated, the presence of the Delaware Trustee of a Delaware Statutory Trust in Delaware ensures that Delaware Trust Law regarding the administration of trusts will apply to the Liquidating Trust, regardless of the location of the other trustees or fiduciaries.¹⁰

The trustees and other fiduciaries of a Delaware Statutory Trust acting as a Liquidating Trust often will act in a fiduciary capacity with regard to one of more classes of beneficiaries, but the relevant Trust Documents may provide that such parties may act in a non-fiduciary capacity.¹¹ If such a party is a fiduciary, her standard of care in the conduct of her duties, absent any changes to the default in the relevant Trust Documents, will be to conduct her actions pursuant to the reasonably prudent person standard.¹² However, Delaware Trust Law permits settlors to craft the Trust Agreement to alter the default standard of care within the confines of Chapter 38, and the Trust Documents also may provide for indemnification or exculpation of such fiduciary in the event she fails to meet such standard.¹³ Notwithstanding the ability to modify the standards of care of fiduciaries and non-fiduciaries providing services to a Delaware Statutory Trust acting as a Liquidating Trust, or the ability to indemnify or exculpate for such breach, such parties have the baseline duty to abide by the *implied covenant of good faith and fair dealing* and may not be exculpated for a bad faith violation of such covenant. ®

Taxation of a Delaware Statutory Trust as a Liquidating Trust

Delaware Statutory Trusts utilized as Liquidating Trusts generally will have the status of a grantor trust for federal income tax purposes.¹⁴ In other words, such trusts will be passthrough entities, and all tax attributes will flow up to the grantors. A transfer of assets under a Plan to the Liquidating Trust for eventual transfer to the Debtor's creditors will be treated as a deemed transfer of such assets to the creditor-beneficiaries and a transfer by such creditor-beneficiaries to the Liquidating Trust.¹⁵ Therefore, the creditor-beneficiaries are the grantors of the Liquidating Trust and will receive the tax attributes of such trust.

This grantor tax status presupposes that the Liquidating Trust is indeed created for the purpose of liquidating and distributing assets and not for the purpose of carrying on a profit-making business. Furthermore, if "the liquidation is unreasonably prolonged or if the liquidation purpose becomes so obscured by business activities that the

declared purpose of liquidation can be said to be lost or abandoned, the status of the organization will no longer be that of a liquidating trust."¹⁶

Pursuant to Rev. Proc. 94-45 issued by the Internal Revenue Service (the "IRS"), the IRS will issue advance rulings classifying Delaware Statutory Trusts utilized as Liquidating Trusts under a Plan as liquidating trusts for purposes of Reg. §301.7701-4(d).¹⁷ Such a ruling will be issued if the following requirements, among others, are met:

- The Liquidating Trust is created pursuant to a confirmed Plan for the primary purpose of liquidating the relevant transferred assets.
- The Plan explains how the Debtor's estate will treat the transfer of its assets to the trust for federal income tax purposes.
- The Trust Documents provide that the creditor-beneficiaries will be treated as grantors and deemed owners of the Liquidating Trust.
- The Liquidating Trust contains a fixed or determinable termination date that is generally not more than five years from the date of creation of the Liquidating Trust; provided, however, that, upon Bankruptcy Court approval with a finding that the extension is necessary to the liquidating purpose of the trust, such term may be extended for a finite period and the Trust Documents require that each extension is approved by the Bankruptcy Court within six months of the beginning of the extended term.
- The investment powers of the fiduciaries of the Liquidating Trust are limited to certain short-term investments, except as necessary to maintain the value of the assets or further the liquidating purpose.
- The Liquidating Trust is required to distribute at least annually to the beneficiaries its net income plus net proceeds from the sale of assets, except to the extent necessary to maintain the value of the assets or meet contingent and disputed claims.¹⁸

It should be noted that the requirements under Rev. Proc. 94-45 are requirements for the issuance of an advance ruling that a Liquidating Trust is a liquidating trust for purposes of Reg. §301.7701-4(d), and that the advance ruling does not explicitly provide for a legal finding that a trust is a liquidating trust for federal income tax purposes.

With regard to Delaware state income tax, the Trust Documents for a Delaware Statutory Trust acting as a Liquidating Trust generally will provide that such trust is intended to be a "qualified settlement fund" within the meaning of Section 468B of the Internal Revenue Code of 1986, as amended (the "*Code*"). By statute, Delaware

imposes no state income taxes on trusts that are qualified settlement funds under the Code.¹⁹ Not all states provide for such favorable tax treatment. This is one of the reasons why Delaware is the jurisdiction often utilized for the creation of a Liquidating Trust.

Securities Law Considerations Regarding a Delaware Statutory Trust as a Liquidating Trust

In addition to the above considerations regarding liquidating trust status for federal income tax purposes, another federal law consideration for a Delaware Statutory Trust utilized as a Liquidating Trust arises under Section 12(g) of the Securities and Exchange Act of 1934 (the “*Exchange Act*”), which could provide that the Liquidating Trust is an issuer of “equity securities” and subject to certain quarterly reporting requirements under the Exchange Act.

With its freedom of contract principles, Delaware Trust Law provides a broad ability to define and limit the scope of the duties of each of the persons engaged in the administration or monitoring of a Delaware Statutory Trust. This feature may be exploited, for example, by Trust Documents governing a Liquidating Trust set up in connection with a confirmed Plan that uses a channeling injunction under Section 524(g) of the Bankruptcy Code to channel asbestos-related liabilities to the Liquidating Trust.

As with an advance ruling from the IRS under Rev. Proc. 94-45, a Liquidating Trust may seek a no-action

letter from the Securities and Exchange Commission (the “*SEC*”) regarding the status of the trust as an issuer of equity securities. Among other considerations regarding whether or not a Liquidating Trust has such status, the SEC will consider the following in connection with the issuance of such a no-action letter:

- Whether the beneficial interests in the Liquidating Trust are transferable or assignable except by will, intestate succession, or operation of law.
- Whether the beneficial interests in the Liquidating Trust are represented by certificates.
- Whether the purpose of the Liquidating Trust is to liquidate and distribute the assets transferred to it.
- Whether the Liquidating Trust will terminate upon the earlier of the distribution of all of its assets in accordance with the terms of the Trust Documents or three years from the date assets were first transferred to it (and whether the Liquidating Trust will request and receive additional no-action assurance from the SEC if its existence is extended beyond such three-year period).
- Whether the trustee or other persons affiliated with the Liquidating Trust will take any actions to facilitate or encourage any trading in the beneficial interests in the Liquidating Trust or any instrument or interest tied to the value of the beneficial interests in the Liquidating Trust.
- Whether the trustee of the Liquidating Trust will file annual reports containing unaudited financial statements and certain other information on Form 10-K and will file current reports on Form 8-K.²⁰

Drafting Tips

In drafting the Trust Documents governing a Delaware Statutory Trust that will be used as a Liquidating Trust, it is important to keep the following in mind:

- Make sure the Liquidating Trust is drafted as a Delaware Statutory Trust—rather than a common law trust—to, in part, avoid jurisdictional issues that could exist with the use of non-Delaware fiduciaries of a common law trust.
- In the absence of a clear limitation of the scope of the duties of the various parties administering or monitoring the Liquidating Trust, such fiduciaries will have all of the duties of a fiduciary under common law.²¹ It is important to set forth the specific duties to be performed by each party and explicitly provide that such party will have no other duties or obligations

under common law or otherwise. This is especially important in the case of the Delaware Trustee, which likely will have a very limited role in the liquidation, and parties with duties and obligations flowing to only one class of beneficiaries.

- Unless there are specific provisions of non-Chapter 38 statutory Delaware Trust Law that are required in connection with the Liquidating Trust, provide that such provisions shall not apply to such trust. Often times, the provisions of Delaware Trust Law other than Chapter 38 will apply to Delaware Statutory Trusts, subject to specific carve-outs.²²
- Depending on the negotiations of the various stakeholders and parties in interest, do not attempt to

limit the standard of care of the various fiduciaries or provide for indemnification and exculpation beyond the limits of Chapter 38.

- Make sure each requirement of Rev. Proc. 94-45 is met to best ensure grantor trust status, and provide an appropriate mechanism in the Confirmation Order and other Trust Documents for the Bankruptcy Court to extend the Liquidating Trust in the event that the liquidating purpose of the trust is not completed within the time allotted. Provide that such Liquidating Trust is a qualified settlement fund.
- Meet the standards for and obtain a no-action letter from the SEC regarding the Liquidating Trust as an issuer of equity securities.

ENDNOTES

¹ See 12 Del. C. §3809.

² See 12 Del. C. §§3303(a), 3825(b).

³ 12 Del. C. §3825(b).

⁴ It should be noted that the Delaware Trustee requirement is replaced with a registered agent requirement in the event that a Delaware Statutory Trust will be a registered investment company, but this likely has little or no applicability in the context of a Liquidating Trust pursuant to a confirmed Plan.

⁵ See 12 Del. C. §53810(a)(1); 3807(a).

⁶ See 12 Del. C. §3806 (providing that a Delaware Statutory Trust may have different classes of beneficial owners and also advisers and other parties with management and similar authority).

⁷ See 12 Del. C. §3313(b).

⁸ 12 Del. C. §3806(c) ("To the extent that, at law or in equity, a trustee ... or other person has duties (including fiduciary duties) to a statutory trust or to another trustee or beneficial owner or to another person that is a party to or is otherwise bound by a governing instrument, the trustee's ... or other person's duties may be expanded or restricted or eliminated by provisions in the governing instrument; provided, that the governing instrument may not eliminate the

implied contractual covenant of good faith and fair dealing ...").

⁹ See 12 Del. C. §3810(d).

¹⁰ With regard to a Delaware common law trust, such trust shall be considered administered in Delaware (and the provisions of Delaware Trust Law shall govern administration) only if: (i) the sole trustee is an individual resident of Delaware or an entity with an office for the conduct of trust business in Delaware; (ii) the trust has more than one trustee, only one of which is an entity (and which entity must have an office for the conduct of trust business in Delaware); or (iii) the trust has more than one trustee, all of which are individuals, and at least half of which live in the State of Delaware. See 12 Del. C. §3340.

¹¹ See 12 Del. C. §3806(c).

¹² See *Cargill Inc. v. JWH Special Circumstances LLC*, 959 A2d 1096, 1111 (Del. Ch. 2008) (discussing the duty of care of a fiduciary of a Delaware Statutory Trust).

¹³ See 12 Del. C. §3806(c); see also 12 Del. C. §3806(e) ("A governing instrument may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a trustee ... or other person to a statutory trust

or to another trustee or beneficial owner or to another person that is a party to or is otherwise bound by a governing instrument; provided, that a governing instrument may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.").

¹⁴ See Reg. §301.7701-4(d).

¹⁵ See Rev. Rul. 63-245, 1963-2 CB 144.

¹⁶ Reg. §301.7701-4(d).

¹⁷ See Rev. Rul. 94-45, 1994-2 CB 684.

¹⁸ See *id.*

¹⁹ See 30 Del. C. §1633(4).

²⁰ See *Response of the Office of Chief Counsel Division of Corporate Finance*, March 28, 2011, available online at www.sec.gov/divisions/corpfin/cf-noaction/2011/remec032811-12g.htm; see also *Response of the Office of Chief Counsel Division of Corporate Finance*, March 28, 2011, available online at www.sec.gov/divisions/corpfin/cf-noaction/2011/behringerharvard033111.htm.

²¹ See *Cargill Inc.*, 959 A2d at 1111 (rejecting argument that Chapter 38 completely preempts trust law or the application of traditional default fiduciary duties for a Delaware Statutory Trust).

²² See 12 Del. C. §3809.

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