

Fine-Tuning Liquidating Trusts

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Liquidating trusts are an increasingly used option for winding up the affairs of a post-confirmation debtor. Liquidating trusts are grantor trusts that are designed to receive the assets of the liquidating debtor for distribution to its creditors, including the rights to recoveries through legal actions. In a liquidating trust, creditors are deemed to have exchanged their claims for beneficial interests in the trust. Ultimately, trust beneficiaries receive pro rata distributions of trust assets with respect to their interests.

Depending on the circumstances, liquidating trusts may be established with high amounts of liquid assets or with precious few. When substantially all of the assets of a company are sold, the

proceeds may be put in a liquidating trust that will distribute the bulk of the assets to allowed claimants. Funds are also held in reserve for potential distribution to disputed claimants upon the completion of the claims reconciliation process.

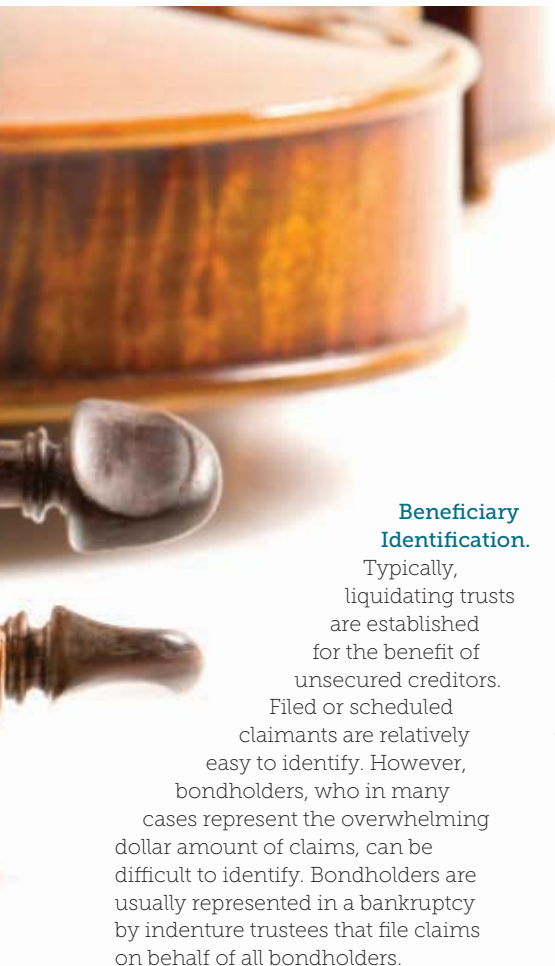
At the other end of the spectrum for liquidating trusts are those that are sometimes known as litigation trusts. These are given little money, or even simply a loan, to pursue litigation for the benefit of the creditors as trust beneficiaries.

Regardless of the financial wherewithal of the trust, thoughtful planning in developing the liquidating trust agreement (LTA) governing the operation of the trust, careful

transitioning from the bankruptcy estate to the trust, and operating efficiencies all enhance the outcome for beneficiaries. This article outlines suggestions for fine-tuning liquidating trusts for optimal performance.

Institutional Knowledge. Frequently, the trustee is the "new kid on the block" and therefore may be ill-equipped to deal with myriad issues and questions that must be addressed, particularly in a trust's early days. Therefore, it is recommended that a trustee establish formal consulting or similar arrangements with one or more former employees of the liquidated operating entity. The amount of time, money, and aggravation saved will be well worth the consulting fees.





Beneficiary Identification.

Typically, liquidating trusts are established for the benefit of unsecured creditors. Filed or scheduled claimants are relatively easy to identify. However, bondholders, who in many cases represent the overwhelming dollar amount of claims, can be difficult to identify. Bondholders are usually represented in a bankruptcy by indenture trustees that file claims on behalf of all bondholders.

Because publicly traded bonds are held in street name, there is no easy way to independently identify the holders. Consequently, the liquidating trustee should make a concerted effort to work with the other parties in the case to obtain the holder information before the effective date of the plan of reorganization.

Without holder information, a trustee could be stuck with the herculean task of tracking down holder information after a trust is established. Bondholders that cannot be located will not be able to reap the benefits of the trust. One way to solve this problem is to arrange for the indenture trustee to continue to represent the bondholders. While this requires a trust to pay additional fees, there are significant benefits in terms of efficiency for the trust and recoveries to bondholder beneficiaries.

Web Site. The LTA should provide for establishment of a Web site for disseminating information to beneficiaries, such as notices, financial information, reports required by the LTA and plan of reorganization, and the trustee's and trust professionals' contact information. The site can also provide ready access to the plan of

reorganization, disclosure statement, LTA, and other useful documents.

Using a Web site saves significant amounts of money for the trust, particularly when it has a large number of beneficiaries. This may be the case for a company with a large number of former employees with severance claims. In most cases, the only communications requiring regular mail are requests for tax identification numbers (TINs), annual grantor trust letters indicating each beneficiary's reportable tax information, and, hopefully, checks for distributions from the trust.

Financial Reporting. In some federal judicial circuits, such as the 3rd, which includes U.S. Bankruptcy Court for the District of Delaware, liquidating trusts are required to file quarterly financial statements with the office of the U.S. Trustee. These reports must also be filed with the court. To provide ready access to trust beneficiaries, these reports can be posted to a trust's Web site.

Regardless of whether such quarterly reports are required, LTAs typically require an independent accounting firm to prepare at least an annual financial statement for the beneficiaries. Some LTAs require semiannual financial statements. However, it is unlikely that the information provided in the additional financial statement would be worth the additional cost. In any event, the appropriate form of report is a compilation. It is not typically necessary to incur the cost of a full audit.

Advisory Board. Typically, a three-member advisory board oversees the trustee. When developing the LTA, this board should give some thought to the decision-making latitude it will give to the trustee. Presumably, the selected trustee is appointed for the person's experience, knowledge, and trustworthiness, and it is inefficient and costly for the trustee to require approvals for relatively small transactions. For that matter, the board members themselves may not want to be consulted on a regular basis. Consequently, the LTA should set reasonable hurdles for board approvals required by the trustee.

Similarly, the trustee should not have onerous board-reporting requirements.

HOT TOPICS

Should a board member desire information, he or she can contact the trustee informally. While it is unlikely that all three board members would resign or cease to serve without being replaced, it would be helpful for the LTA to provide for such a situation. For example, one possibility if that were to happen would be for the board to be dissolved and for the trustee to have no further obligations to the board.

Insurance. Two key risk areas for which trusts should strongly consider obtaining insurance coverage are, first, to protect the assets of the trustee, the trust advisory board, and the trust in case third-party claims are made against them and, second, to protect the assets of the trust from theft or misappropriation.

The LTA should provide appropriate indemnification to both the trustee and the trust advisory board members. However, if the trust does not have sufficient assets to satisfy the contractual indemnity obligations of the LTA, then the indemnification is of little value. Furthermore, it is possible that allegations made by a plaintiff are not indemnifiable for any number of reasons.

Therefore, to provide adequate protection, it is highly recommended that a management liability insurance policy, also known as an errors and omissions (E&O) policy, be obtained. A properly written policy protects the trust, the trustee, and the trust advisory board members from such claims and covers both defense costs incurred and any judgment or settlement reached with a plaintiff.

There are two effective ways to protect trust assets from theft, embezzlement, or other misappropriation. The first is a surety bond, which is similar to the type of bond that a builder might post to protect a property owner in case the builder did not perform to specifications. It is also the same type of bond that the U.S. Trustee requires of Chapter 11 and Chapter 7 trustees. The bond compensates the trust if the trustee does not perform as promised.

The second option is a fidelity bond, which is also known as "crime insurance." Although it is called a "bond,"

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it is actually an insurance policy that protects the trust against dishonest acts by a trustee that results in losses to the trust. The requirements for both bonds are based on the applicant's financial condition and good character. A qualified insurance broker can advise the trust regarding the most appropriate and cost-effective coverage.

Litigation Recoveries. Liquidating trusts often have very tight budgets. Yet the main source of post-confirmation recoveries is litigation, which can run the gamut from run-of-the mill preference actions to multimillion-dollar fraudulent transfer suits. In either case, the trustee should consider retaining contingency counsel to prosecute lawsuits. While this might mean foregoing 25-35 percent of the proceeds, it allows the trust to recover funds that may otherwise be unattainable.

Though less common, another technique a trust could explore is litigation funding, in which a third party lends money on a non-recourse basis in exchange for a sizable piece of litigation recoveries and interest on funds advanced. One major benefit to litigation funding is the potential willingness of the funder to pay for experts for litigation. Experts can be quite costly, but without them a trust may not be able to prosecute its case. A funder may also be willing to advance funds for general operations of the trust. This can be extremely important, particularly when a trust is granted only a meager allocation of funds through the plan of reorganization.

Most contingency counsel will not front the costs of experts or any other costs of operating the trust. Litigation funders are more open-minded and may be willing to negotiate funding the trust's litigation and operating expenses as part of the funding package.

Unclaimed, Undeliverable Distributions. To make distributions, a trust must have each beneficiary's name, address, and TIN. If it has correct addresses, a trust can contact creditors to obtain their TINs. This is usually done by mail in a letter explaining that the beneficiary will be ineligible for distributions unless the TIN is submitted to the trustee on a W-9 or equivalent form. However, despite a trustee's efforts, tax data may not be forthcoming. Furthermore, unless beneficiaries inform a trustee of a change of address or the



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U.S. Postal Service (USPS) provides forwarding information, distributions to these beneficiaries cannot be made.

A relatively painless and inexpensive way to cut down on the number of beneficiaries with outdated addresses is to arrange for access to a publicly available database of USPS change-of-address requests. Other than requiring simple searches of this nature, the LTA should not burden a trustee with doing detective work to track down beneficiaries.

Final Distribution, Dissolution. As the final distribution approaches, a trustee should investigate the sale of unidentified and remnant assets. These may range from escheated checks to anticipated payments that do not warrant keeping the trust open to collect. If the final distribution is likely to be made near the end of a year, every reasonable effort should be made to complete the task before year-end to save the trust the costs of filing a tax return for an additional year and preparing another annual financial statement.

An LTA can provide that any funds held in reserves, such as those for beneficiaries with missing addresses or TINs, can be released to the general fund for distribution to all beneficiaries. Funds remaining from final distribution checks that are not deposited by their stale date (usually 60 or 90 days) can be packaged with the sale of remnant assets so that the purchaser of the remnant assets receives those funds. LTAs can provide that any funds remaining in the trust at the time of dissolution may be donated to a charity.

Careful Review

LTAs should be reviewed carefully by all parties, especially by prospective trustees. One should not assume that all LTAs are the same. The dense text may appear to be boilerplate language. In fact, frequently it is just an LTA from a previous trust with the names changed by the current drafter. By devoting careful attention to details and remaining mindful of facts particular to the situation, a trust should run smoothly and efficiently. ■

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