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Chapter 11 Plan Provision for Liquidating Trustee Upheld

-by Robert P. Achenbach, Jr., J.D.

In a recent Chapter 11 bankruptcy case, a partnership debtor attempted to circumvent a negotiated liquidation in case of a potential plan default but was defeated by established bankruptcy and federal tax provisions. One can imagine that the creditors were placated by the Chapter 11 plan liquidation provision, and the court refused to allow the debtor to use legal maneuvers to pull the negotiated "rug" out from under the creditors.

In re Schroeder Bros. Farms of Camp Douglas LLP[1]

The debtor was a limited liability partnership (LLP) which was taxed as a partnership and which owned and operated a dairy farm but had to file for Chapter 11 because the debtor's liabilities exceeded the limit ($4,411,400 in 2016 through 2019) for Chapter 12 eligibility.1[Section 101(18)(B).] The debtor's plan was confirmed and included a "liquidation provision" which provided that, if the debtor defaulted on required plan payments, the Committee of Unsecured Creditors (the Committee) could petition for appointment of a liquidating trustee after giving the debtor 30 days notice of the default. The debtor did default on plan payments and the committee filed a motion for appointment of the liquidating trustee.

Proposed Solution #1. The debtor objected to the motion on the grounds that any sale of assets would create substantial capital gains tax, sufficient to render the bankruptcy estate insolvent. To solve this problem, the debtor proposed to convert the case to Chapter 12 to take advantage of Section 1232 which allows Chapter 12 debtors to sell farm property and treat the capital gains as an unsecured claim of the estate.[2] Because the plan payments had reduced the debtor's debts, the debtor was now eligible for Chapter 12, at least under the debt limit requirements.

The Committee argued that a conversion to Chapter 12 was not possible because the eligibility of the debtor for Chapter 12 is determined at the date of the original petition in the case, not the date of the conversion. Section 1112(f) prohibits the conversion of a Chapter 11 case to another chapter unless the debtor is qualified for the new chapter. Although a conversion order constitutes an order for relief for the new chapter filing, under Section 348(a) the conversion ". . . does not effect a change in the date of the filing of the petition, the commencement of the case, or the order for relief."[3] Thus, the court held that because the debtor was not eligible for Chapter 12 on the original date of the petition, the debtor could not later convert to Chapter 12.

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In addition, the court noted that Section 1232 would not help the debtor because, as a partnership, all income and deductions flow through to the partners and would not affect the financial status of the partnership in bankruptcy. This issue raises the second proposed solution.

Proposed Solution #2. To remove the partnership problem, the debtor proposed to make the election under Treas. Reg. § 301.7701-1(c) to be taxed as a corporation and removing the pass-through of the capital gains. The court agreed that the debtor was eligible for the election but raised the issue as to whether the election would violate the absolute priority rule of Section 1129(b)(2)(B).[4]

The absolute priority rule provides that a plan is not fair and equitable to a class of unsecured creditors if a junior creditor, including the debtor, receives or retains any interest in bankruptcy estate property and the unsecured creditors receive less than full payment for their claims.[5]

The court cited *In re Perez*[6] that the absolute priority rule prohibits "the bankruptcy court from approving a plan that gives the holder of a claim anything at all unless all objecting classes senior to him have been paid in full." In this case, the court found that allowing the election to corporation status would be unfair to unsecured creditors in that the effect of the election would remove assets which would be available to the unsecured credits while leaving the partners no longer directly taxed on the capital gains. The court noted that the debtor and creditors had negotiated the liquidation provision and had sufficient notice of the ramifications of a default by the debtor.

Appointment of the Trustee

The debtor also challenged the authority of the court to appoint a trustee. Section 1104(a) authorizes a court to appoint a trustee "for cause, including fraud, dishonesty, incompetence, or mismanagement" or "if such appointment is in the interests of creditors . . .." A court may appoint a trustee under Section 1104(a) only after commencement of the case and before confirmation of the plan. Here the plan was confirmed prior to the arise of the default and application of the liquidating agreement. However, the court noted that Section 1123 authorizes provisions in a plan permitting the appointment of a trustee.

The court cited *In re Ionosphere Clubs, Inc.*[7] for four factors to use in determining whether an appointment of a trustee is in the best interests of creditors: "(i) the trustworthiness of the debtor; (ii) the debtor in possession's past and present performance and prospects for the debtor's rehabilitation; (iii) the confidence-or lack thereof-of the business community and of creditors in present management; and (iv) the benefits derived by the appointment of a trustee, balanced against the cost of the appointment." Thus, the court found that the appointment of a liquidating trustee was in the best interests of the debtor and creditors, particularly because the parties had negotiated this solution for a plan default, indicating that the creditors found this procedure to be in their best interests.

In Conclusion

The case does not discuss why the debtor choose Chapter 11 instead of taking steps to qualify for Chapter 12, but the debtors default was blamed on deteriorating market conditions and that cause would arise in either Chapter 11 or 12. Plus the existence of the liquidating provision for the trustee demonstrated that the debtors and creditors were aware of the potential for the confirmed plan to fail. Thus, the attempt to circumvent the liquidating provision through legal maneuvers was insufficient to overcome the economic hazards of dairy farming.

ENDNOTES

[1] 2019 Bankr. LEXIS 1705 (Bankr. W.D. Wis. 2019).

[2] See Harl and Achenbach, *Agricultural Law*, § 39.04[4][b] (2019).

[3] See, e.g., *In re* Campbell, 313 B.R. 871 (Bankr. 10th Cir. 2004); *In re* Ash, 539 B.R. 807 (Bankr. E.D. Tenn. 2015).

[4] Note that Chapter 12 does not contain the same "cram-down" provision as in Chapter 11, although Chapter 12 has its own cram-down rule. Likewise, there is no absolute priority rule in Chapter 12.

[5] See Harl and Achenbach, *Agricultural Law*, § 120.05[5][g] (2019).

[6] 30 F.3d 1209, 1214 (9th Cir. 1994).

[7] 113 B.R. 164 (Bankr. S.D. N.Y. 1990).

CASES, RULINGS, REGULATIONS AND STATUTES

FEDERAL ESTATE AND GIFT TAXATION

DISCLAIMERS. The taxpayer was the income beneficiary of three trusts. The taxpayer utilized the disclaimer provisions expressly provided in the three trusts and disclaimed the life estates. At the time the taxpayer executed the disclaimers, the taxpayer had been medically diagnosed as suffering from cancer, was in hospice care and had a medical prognosis of at least a 50 percent probability that the taxpayer would die within one year. However, the taxpayer died five days later. The disclaimer constituted completed gifts to the owners of the remainder interests in the trusts. The executors of the taxpayer's estate sought a ruling as to the applicable actuarial factor to be used in valuing the disclaimers of the life estates. Treas. Reg. § 25.2512-5(a) provides that, except as otherwise provided in Treas. Reg. §§ 25.2512-5(b) and 25.7520-3(b), the fair market value of annuities, unitrust interests, life estates, terms of years, remainders, and reversions transferred by gift, is the present value of the interests