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A PRACTICAL GUIDE TO BANKRUPTCY-
PROOFING SETTLEMENT AGREEMENTS

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A Practical Guide to Bankruptcy-Proofing Settlement Agreements

By Mitchell E. Ayer and Evelyn I. Breithaupt

Although litigants often enter into settlement agreements to avoid the uncertainty of months of litigation and the potential of no payout, a bankruptcy filing by the paying party under the settlement can lead to the same uncertain result. After entering into a carefully negotiated settlement agreement and promising to pay a claimant in exchange for the release of claims, the party being released may well turn around, file for bankruptcy, and see the settlement obligations released. Preventing this result, especially when the proposed agreement involves a structured settlement to be paid out over time, requires the advice of an experienced bankruptcy attorney. In almost any settlement situation, a few practical tips apply:

- Get paid as soon as possible.
- Take a lien (as soon as possible).
- Make sure the settlement agreement preserves your rights.

Even when the claimant follows this advice, there are a number of potential pitfalls. The first is that any settlement payment may be avoidable as a preference

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1 This practical guide draws from the forthcoming Lexis Practical Guidance Article “Analyzing Settlement Agreements,” by Ira L. Herman and Evelyn I. Breithaupt. Mr. Herman is a Senior Partner in Thompson & Knight, LLP’s New York office.
or even as a fraudulent transfer. The second is that protective provisions in a settlement agreement, such as a stipulation that the debt is non-dischargeable, may be unenforceable in bankruptcy as a violation of public policy. But a prepared party can enter into settlement negotiations with the tools to avoid most of the major risks and to use the likely treatment of the settlement obligation in bankruptcy to its advantage.

**Risk of Discharge**

The risk of discharge can be protected against in two basic ways: (1) get paid, and (2) get a lien. Getting paid quickly starts the clock running for any preferential transfer claim, as discussed below. A claimant also should not release its claims until it receives the full amount of the agreed settlement payment. However, immediate payment is frequently not an option, especially if the paying party lacks cash, and thus is precisely the type of party likely to file for bankruptcy and seek a discharge of any settlement obligation. And if the paying party proposes to pay out a settlement amount over time, refusing to release the claims until the obligation is paid off will not do much good. By the time the paying party defaults under the agreement or files for bankruptcy, the statute of limitations for the claims may well have run, leaving the claimant with nothing more than a dischargeable contractual obligation to pay.
One way to incentivize the paying party to pay upfront is to settle for a lesser amount, conditioned on payment by a date certain. If payment is not made by that date, then the debt increases to a larger amount. This encourages the settling party to pay the agreed reduced amount upfront or more quickly. If the settling party files bankruptcy, he will likely try to take advantage of the lesser amount as being the new compromised debt. But if properly drafted with condition rather than covenant language, the settling party may be stuck with the larger amount because the early payment condition was not satisfied.

When immediate payment is impossible, and a proposed structured settlement could push the payment of the claim out far beyond the statute of limitations, the claimant can best protect its interests by taking a lien or security interest in assets sufficient to pay the full amount. Thus, if the settling party files for bankruptcy, the claimant will have a secured claim and, assuming the value of its collateral is sufficient to cover the claim, will be paid in full—as long as its lien or security interest is not avoided as a preference or fraudulent transfer.

A claimant can gain further assurance by requiring a guaranty, which may be necessary if the potential debtor does not have sufficient collateral to secure the settlement obligation. Further, a claimant may be able to disincentivize a bankruptcy filing by obtaining a “bad-boy” guaranty that springs into effect if the debtor files for bankruptcy.
Preserving Exceptions to Discharge

Causes of action that would give rise to non-dischargeable claims under § 523 of the Bankruptcy Code pose another risk: that the paying party will file for bankruptcy and convert what should be a non-dischargeable obligation into a dischargeable contractual debt. The best way to preserve the non-dischargeability of a debt is to be aware of whether the underlying facts would support an exception to discharge under § 523, obtain a stipulation to those facts wherever possible, and, in any event, expressly provide that the settlement agreement does not constitute a release of the claimant’s right to seek a determination of non-dischargeability under the Bankruptcy Code.

A provision in the settlement agreement stating, without factual support, that the settlement obligation is non-dischargeable in bankruptcy is generally unenforceable as against public policy. A debtor in bankruptcy may not waive its right to a bankruptcy discharge before filing for bankruptcy, even as to a specific debt. A claimant should thus be cautious of bargaining for such an unenforceable provision. Even if the settlement agreement states that the basis for the claim is

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“alleged fraud” (or some other basis for non-dischargeability), such a statement will likely have no effect in the bankruptcy court and will instead be interpreted as an unenforceable waiver of discharge.³

Although a pre-petition waiver of discharge is generally unenforceable, a stipulation as to the facts supporting an exception to discharge under § 523 may well be enforceable.⁴ For example, where the underlying claim is based on fraudulent misrepresentations, the paying party may stipulate as to the elements of a fraudulent misrepresentation action under § 523(a)(2)(A). (If there is any risk that the debtor could file bankruptcy in one of several circuits which may have slightly different elements for non-dischargeability claims, the settlement agreement should, where possible, stipulate as to facts sufficient for all.)

At best, a stipulation in a consent judgment may be given collateral estoppel effect, thus settling the issue of the debt’s dischargeability without the need for any litigation before the bankruptcy court. Whether a consent judgment has collateral estoppel effect depends on where the consent judgment is entered.⁵ A consent

³ Simmons Capital Advisors, Ltd. v. Bachinski (In re Bachinski), 393 B.R. 522, 533 (Bankr. S.D. Ohio 2008) (an agreement that a settled claim was based on “allegations of fraud” and an agreement to waive discharge was an unenforceable waiver of discharge).
⁴ See Klingman v. Levinson, 831 F.2d 1292, 1296 n.3 (7th Cir. 1987) (determining that consent judgment proved debt was nondischargeable where parties stipulated to facts establishing the elements of § 523(a)(4) and stating, “For public policy reasons, a debtor may not contract away the right to a discharge . . . . [but] a debtor may stipulate to the underlying facts that the bankruptcy court must examine to determine whether a debt is dischargeable.”).
⁵ See Bachinski, 393 B.R. at 535-36 (“The issue of whether consent judgments have issue-preclusive effect has divided the courts . . . . Courts have split into three camps on this question:
judgment in federal court does not have collateral estoppel effect under federal common law, because federal courts do not interpret the issues involved in a consent judgment as having been actually litigated. However, a number of states give collateral estoppel effect to facts stipulation in a consent judgment. Under Texas law, a consent judgment “is as conclusive as any other judgment as to the matters adjudicated.” Because the collateral estoppel effect is predictable, the claimant can and should be aware of whether it is worthwhile to bargain for such a stipulation. Further, an awareness that a consent judgment in Texas court may well have conclusive effect as to the facts establishing nondischargeability, while a consent judgment in a federal court will not, should inform parties’ decisions as to where to file a claim.

Of course, most settling parties will be unwilling to enter into such a stipulation. Particularly where the claim is based on embarrassing or disreputable non-dischargeable grounds, such as fraud or defalcation in a fiduciary capacity, the desire to avoid having such facts made public may be part of the motivation for settlement.

(1) yes, (2) no and (3) only if the parties clearly express their intent that the consent judgment should have issue-preclusive effect.”); see Ballobin, supra note 2, at 383-91.

6 E.g., Arizona v. California, 530 U.S. 392, 414 (2000) (“In the case of a judgment entered by confession, consent, or default, none of the issues is actually litigated. Therefore, [issue preclusion] does not apply.”).

Unless the settlement agreement provides otherwise, a settlement does not decide the issue of dischargeability. Under the Supreme Court’s decision in *Archer v. Warner*, courts are required to look behind a settlement agreement to the underlying facts giving rise to the released claim. After *Archer*, if the facts satisfy the elements of an exception to discharge under § 523, the claim is non-dischargeable, unless the settlement agreement expressly provides otherwise.9

Thus, unless the settlement agreement explicitly extinguishes the underlying obligation and disavows any claim for non-dischargeability, the settlement agreement is regarded as a debt arising out of the underlying facts of the claim, not a completely new obligation.10 A paying party would thus benefit from provisions that state that a the settlement is intended to resolve all issues relating to the underlying allegations and (if possible) agreeing that the settlement amount is dischargeable in bankruptcy.

The claimant should likewise be careful to avoid any language in a settlement agreement that could support an argument that the settlement resolves the issue of dischargeability. Language to avoid, for example, is any suggestion that the settlement agreement fully resolves all claims and factual issues—the type

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9 *Id.* at 319 (despite settlement of fraud claims, the debt created by the settlement agreement was “a debt for money obtained by fraud, within the terms of the non-dischargeability statute”).
10 *Id.* at 322 (noting that there was no evidence that “the parties meant to resolve the issue of fraud or, more narrowly, to resolve that issue for purposes of a later claim of non-dischargeability in bankruptcy).
of language that may indicate that the parties, unlikely the parties in Archer, actually intended to settle the issue of dischargeability. Out of an abundance of caution, the claimant may seek language that expressly preserves its rights to bring an action contesting the dischargeability of the settlement obligation if the paying party files for bankruptcy, in order to reduce the risk that the settlement agreement’s release language could be interpreted too broadly as applying to the issue of dischargeability.

A paying party who may wish to avoid a public trial on the facts giving rise to the exception to discharge may prevent such an outcome by granting a lien or security interest in collateral sufficient to cover the claim. If the claimant is fully secured, the dischargeability of the debt will be a moot point, and there will be no need for a lengthy trial.

Similarly, the claimant who believes the facts support an exception to discharge under § 523 but nevertheless wishes to avoid the expense of litigating an exception to discharge may accomplish this end by taking a lien or security interest. The claimant’s awareness, during the settlement negotiation process, of the possibility of bringing an exception to discharge in a bankruptcy may give it a bargaining chip to obtain a lien or security interest where the paying party would otherwise be unwilling. The claimant should, however, be aware of the risk that its lien will be avoidable in the event of a bankruptcy filing, since the claimant, unlike
the paying party, has no control over whether and when a bankruptcy case may be filed.

Domestic support obligations and divorce debts are a special case. Because the Bankruptcy Code excepts from discharge any domestic support obligations or other debts arising out of a settlement agreement, divorce decree, or other order of a court of record (§ 523(a)(5) and (15)), a party entitled to receive payments under such an agreement should make sure that the obligations are characterized as either a domestic support obligation or a divorce debt. This is particularly important where the form of the support obligation or divorce debt is something other than a requirement to pay alimony—for example, when the debt is an obligation to pay ongoing mortgage payments. If the basis for the agreement to pay should fall within § 523(a)(5) or § 523(a)(15), the settlement agreement should specifically recite that this is the case, reducing the likelihood that there will be litigation over whether the debt is properly characterized as a domestic support obligation or divorce debt.

Avoidance Actions

Even if the claimant does everything correctly and obtains payment in full or a lien on collateral sufficient to cover the full amount of the settlement obligation, the claimant runs the risk that the payment or the lien may be avoidable as a
preferential or fraudulent transfer or under the trustee’s or debtor-in-possessions
strong-arm powers under § 544 of the Bankruptcy Code.

Even when the claimant is being paid in full upfront, the settlement agreement should not provide for the release of claims until 91 days after the payment is made, thus ensuring that the claims will not be released while the claimant is still exposed to the avoidance of the settlement payment.

With a structured settlement, where the paying party’s debts are primarily commercial the amount of each payment should (if possible) be determined so that the total amount of payments in any 90-day period falls within the safe harbor in § 547(c)(9). (This suggestion works only for smaller settlements.)

Finally, a claimant may negotiate to have settlement payments made by a third party. Assuming that the third party’s funds would not be property of the potential debtor’s estate, the payments are not avoidable as preferences because they are not transfers of property of an interest of the debtor in property under § 547(b). A similar suggestion is that the settlement payments could be made from “earmarked” funds, which are not considered to be property of the debtor. Of course, these suggestions run the risk that the debtor and the third party could be substantively consolidated in bankruptcy, or that there could be a claim for veil-piercing or reverse veil-piercing—particularly where a debtor has sufficiently close ties to the third party to get that party to agree to such an arrangement.
**Post-Petition Settlements**

If a claim has not yet been settled and the party asserting the claim files for bankruptcy, any settlement agreement will be subject to court approval.\(^{11}\) To determine whether to approve the settlement, the court looks to whether the settlement is “fair and equitable”—that is, the “fairness of the settlement to other persons, i.e., the parties who did not settle.”\(^{12}\) Courts generally consider the following factors in determining whether the settlement is fair and equivalent: (1) the probability of success in litigation; (2) the likely difficulties in collection; (3) the complexity of the litigation involved, and the expense inconvenience, and delay necessarily attending it; and (4) the paramount interest of creditors.\(^{13}\)

Additionally, when the settlement could actually be construed as a sale of assets under § 363, the parties should be mindful of § 363’s requirements.\(^{14}\)

A note when one party is settling a claim that it has brought on behalf of the estate: A creditor that brings a claim on behalf of the estate needs to be careful

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\(^{11}\) See Fed. R. Bankr. P. 9019(a).

\(^{12}\) *Will v. Northwestern Univ. (In re Nutraquest, Inc.)*, 434 F.3d 639, 645 (3d Cir. 2006).


when the creditor’s claims are also settled that it has not somehow breached a fiduciary duty to the estate by putting its own interests first.

**Conclusion**

An awareness of the effects a bankruptcy filing would have on a proposed settlement agreement can help you not only to protect your interests in settling a claim, but also to be aware of the factors that are likely to influence the other party’s negotiations. A party asserting a claim for fraud, for example, should be aware that the other party’s desire to avoid potentially embarrassing litigation of the underlying facts may give leverage for obtaining additional security for payment or even upfront payment. A potential debtor settling a claim, similarly, will want to be aware of the kinds of bankruptcy-proofing provisions the other party may find valuable, and should negotiate accordingly.
Checklist for Settlement

Claimant:

○ Am I being paid in full upfront?
  ▪ Is the debtor being released or are the claims being dismissed with prejudice 91 days after I am being paid in full?

○ If I am not being paid in full upfront, is there any security for the payment obligations?
  ▪ Do I have a lien and/or security interest?
  ▪ Do I have another form of payment security, such as a guaranty? (Possibly a bad-boy guaranty?)
  ▪ Is the collateral sufficient to cover the settlement obligation?
  ▪ Did I perfect the lien and/or security interest as soon as possible?

○ If I am releasing claims in exchange for a structured settlement, do I retain the right to seek a determination that the settlement obligation is non-dischargeable?
  ▪ Is there a consent judgment with stipulated facts supporting an exception to discharge?
  ▪ Is there a provision stating that in the event that a bankruptcy or other insolvency proceeding would result in the settlement not being paid in full, I retain the right to seek an exception to discharge?
  ▪ If the settlement resolves a family law dispute, are any amounts owed to me a domestic support obligation (nondischargeable under § 523(a)(5)) or a debt incurred in connection with a separation agreement, divorce decree, or other order of a court of record (nondischargeable under § 523(a)(15))? Does the settlement recognize the nature of the debt?
Potential Debtor:

- Have I used my bargaining power to grant bankruptcy-protective provisions in exchange for a lower settlement amount?

- Have I exposed myself to the risk that despite the settlement, I could still be sued for an exception to discharge?
  - Is there a provision that would support an argument that the settlement releases claims for exception to discharge?
  - Do the facts giving rise to the claim fall within an exception to discharge under § 523(a)? Did I grant a lien or security interest to avoid litigation over dischargeability?