

# Settlement Agreements in Bankruptcy

A Practical Guidance® Practice Note by Ira L. Herman, Blank Rome LLP



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This practice note discusses settlement agreements and the various risks to the settling parties in a bankruptcy case. Settlement agreements, and the certainty that is supposed to be created by such agreements, are subject to several risks in the context of a bankruptcy filing by one of the settling parties.

First and foremost, there is the risk that the party against whom the claim has been asserted will obtain a release in exchange for a promise to pay (e.g., through a structured settlement) and then file for bankruptcy and discharge the payment obligation. Although this risk can be mitigated if the releasing party secures the payment obligation, the lien or security interest could be subject to claw back, as a preferential transfer, in the event the party that has granted the lien or security interest were to be in a bankruptcy case commenced within 90 days of the perfection of such lien or security interest. Even when a settlement payment is made up-front, in cash, there is a risk that the payment could be avoided as a preference or as a fraudulent transfer. Although these risks cannot be eliminated, they can be mitigated by careful drafting.

This practice note addresses settlement agreements in bankruptcy as follows:

- The Discharge Risk
- Avoidance
- Bankruptcy Court Approval of Settlements
- Settlement Agreement Checklist

For related content, see [Rule 9019 Settlement Agreements, Preferences, Fraudulent Conveyances versus Preference Actions](#) and [Fraudulent Transfers](#). For clauses that can mitigate the risks discussed in this practice note, see [Settlement Agreement Clause\(Bankruptcy Effect on Released Claims\)](#), [Settlement Agreement \(Anticipating Fraudulent Transfer Challenges\)](#), and [Settlement Agreement \(Anticipating Preferential Transfer Claims\)](#).

## The Discharge Risk

When parties settle before a bankruptcy filing, the primary risk with respect to settlement agreements is that the party required to make one or more payments under the agreement in exchange for a release will obtain a discharge of its payment obligation. The recipient of the payments (i.e., the releasing party) may then be in a situation in which it will not receive the full amount of the settlement and will not be able to successfully assert its original claim against the bankruptcy estate. This risk arises most frequently when the settlement is a structured settlement providing for payments over time.

As a practical matter, if the paying party is not financially sound, one way for the releasing party to counter this risk is to draft a settlement agreement that grants a security interest in collateral sufficient to cover the amount of the structured settlement. The security interest must then be perfected in accordance with applicable non-bankruptcy law. If the paying party later files for bankruptcy, the releasing party will have a secured claim against the estate and will then be paid in full (assuming the value of the collateral is sufficient to cover the amount of the claim). The releasor that secured a payment stream by taking collateral remains subject to the risk that the transfer of the collateral will be subject to attack as a preferential transfer.

If the underlying claim giving rise to the settlement would be a non-dischargeable obligation under Section 523(a) of the Bankruptcy Code (e.g., for fraud), the releasing party should seek provisions in a settlement agreement that clearly state the basis for the agreement and thus preserve the non-dischargeable character of the claim—or, better yet, agree to the entry of a stipulated judgment. If, for example, the underlying claim is one based on fraud, willful and malicious injury, or defalcation in a fiduciary capacity (to name a few common categories of non-dischargeable debt), the settlement agreement can explicitly state the grounds of the debt being paid in language that tracks the elements of non-dischargeability under Section 523(a). Courts generally enforce post-petition settlement provisions setting forth the non-dischargeability of the debt in bankruptcy but hold that pre-petition waivers of dischargeability are unenforceable. See *Lichtenstein v. Barbanel*, 161 F. App'x 461, 468 (6th Cir. 2005); *Saler v. Saler* (In re Saler), 205 B.R. 737 (Bankr. E.D. Pa. 1997).

A pre-petition stipulation as to the facts giving rise to the underlying claim may, however, be enforceable, particularly if it is entered by a court as part of a consent judgment. See *Klingman v. Levinson*, 831 F.2d 1292, 1296 n.3 (7th Cir. 1987) (determining that consent judgment proved that debt was non-dischargeable where parties stipulated to facts establishing the elements of Section 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.”). The issue preclusive effect of such a stipulation is determined by applicable collateral estoppel law. A consent judgment in federal court does not have issue preclusive effect; the collateral estoppel effect of such a consent judgment in state court is determined pursuant to state law. See *Bay Area Factors v. Calvert* (In re Calvert), 105 F.3d 315, 317 (6th Cir. 1997) (holding that the collateral estoppel effect of a state court default judgment in a non-dischargeability action was based on applicable state law). The stipulation must include a specific admission of the elements for one of the non-dischargeability grounds in Section 523 of the Bankruptcy Code. A bare assertion that a claim is based on “allegations of fraud,” together with an agreement that the debt is non-dischargeable, is not sufficient without actual admissions of the facts.

Many settling defendants will be unwilling to stipulate that the settlement amount is based on non-dischargeable grounds because such a stipulation would amount to an admission, for example, of a fraud, defalcation, or willful and malicious injury. The releasing party may instead seek to include a provision that preserves its original claims, including the issue of non-dischargeability, in the event that

a bankruptcy or other insolvency proceeding is filed and it does not receive or is not allowed to retain the full amount of the settlement payment.

If the releasing party fails to include provisions protecting the non-dischargeable character of the debt, the obligation may be transformed into a mere contractual obligation dischargeable in bankruptcy. This would be true particularly if the settlement involves the entry of a judgment converting an unliquidated claim into a fixed debt obligation, without a clarification that the claim is subject to non-dischargeability. See *Burtch v. Gannon* (In re Cybersight LLC), No. 04-112, 2004 U.S. Dist. LEXIS 24426 (D. Del. Nov. 18, 2004).

Usually, however, a settlement agreement will not be interpreted as rendering the settlement obligation dischargeable. Following the Supreme Court’s ruling in *Archer v. Warner*, 538 U.S. 314 (2003), courts are required to look behind the settlement to the underlying cause of action to determine dischargeability as long as the terms of the settlement agreement do not direct otherwise. A releasing party should make sure that no language in the settlement agreement explicitly or implicitly renders the settlement obligation dischargeable. The paying party should bargain for a stipulation that the execution of a promissory note extinguishes the underlying cause of action and, if possible, that the debt created by the promissory note is dischargeable, thereby increasing the possibility that the settlement obligation will be dischargeable in the event of a bankruptcy filing.

## Avoidance

Even when the settlement amount will be paid all at once, the party receiving the payment risks avoidance of the payment in bankruptcy, either as a fraudulent transfer or (more likely) as a preferential transfer. While it has been argued that the dismissal of litigated claims is “new value” and thereby excepted from preference risk under Section 547(c)(1) of the Bankruptcy Code, this reasoning is suspect at best and a settling plaintiff has to address the preference risk just as any creditor receiving payment on account of an antecedent debt within the preference avoidance period. See *In re VasuFabrics Inc.*, 39 B.R. 513 (Bankr. S.D.N.Y. 1984) (settlement payment is for antecedent debt, even if the payment is made before the settlement agreement is executed). When the entire settlement amount is paid at once, the releasing party receives the entire amount agreed to under the settlement agreement. If, however, the payment is made less than 90 days before the paying party files for bankruptcy relief, the releasing party may be required to turn over the settlement payment to the estate since the amount received (the entirety of the settlement

amount) is almost certainly greater than the amount that the releasing party would have received on account of its claim in a Chapter 7 distribution. Similarly, if the releasing party takes a security interest in the prospective debtor's property to secure a structured settlement, the security interest will likely be subject to avoidance as a preference if the other party files for bankruptcy less than 90 days after the perfection of the security interest.

As a practical matter, one way to mitigate this risk is to arrange for the payment (and/or the attachment and perfection of the security interest) to be made as soon as possible to lessen the likelihood that the paying party will need to file for bankruptcy within 90 days. Of course, if the settlement payment itself precipitates the filing, requiring an earlier payment may not help. If the payment of the settlement is likely to result in insolvency, the releasing party may choose to defer payment by 90 days while taking a security interest in noncash assets.

Although the security interest itself could be subject to avoidance as a preference for up to 90 days after perfection, both the security interest and subsequent payments will, after the 90-day window has passed, be protected from avoidance, since payments on a secured obligation are not avoidable preferences. Securing the obligations under the settlement agreement can therefore reduce the risk of avoidance of payments in a deferred or structured settlement.

With a structured settlement, if the paying party's debts are primarily commercial, the settlement payments may also be protected against avoidance if the total amount of the payments during any 90-day period falls below the threshold for an avoidance action set forth in Section 547(c)(9) of the Bankruptcy Code. This safe harbor is available only in the case of smaller settlements.

Additionally, if possible, the releasing party can require settlement payments to be made by a third party. If the funds used to pay the settlement would not have been property of a debtor's bankruptcy estate, the transfer should not be avoidable as a preference. Similarly, the settlement may be structured so that a third party lends money to the debtor to make the settlement payments. Such earmarked funds are not considered part of the bankruptcy estate, and the transfer of the funds is therefore not an avoidable preference. On the other hand, where the paying party has sufficient influence over another entity to make third-party payment or earmarking feasible, there may be a risk that the entities will be substantively consolidated in bankruptcy. In that event, the transfer would be of funds of the consolidated estate and would be subject to avoidance as a preference. Third-

party payment should therefore be used in conjunction with other protective provisions.

Additionally, the releasing party may include in the settlement agreement a provision delaying the release of claims until 91 days after payment, the time at which the payment would be protected from avoidance, assuming that the debtor is not an insider of the releasing party (the insider preference reach back period is one year, rather than 90 days). This mechanism is often times referenced as a "springing release." To implement a springing release, the settlement agreement should say that the claim will not be reduced or released until 91 days have passed after the last payment without a bankruptcy filing. The settlement agreement should also include a provision acknowledging that the full claim remains in effect for all defense purposes (e.g., to defend any claims brought by the debtor or creditors). Although it is possible that such a provision may be regarded as an ipso facto clause under Section 365(d) of the Bankruptcy Code, the provision likely could serve to protect the releasing party against a worst-case scenario in which the releasing party is required to return a settlement payment, while being simultaneously barred from asserting its claims against the debtor arising from the same transaction or occurrence.

See generally *I.T.T. Small Business Finance Corp. v. Frederique*, 82 B.R. 4 (Bankr. E.D.N.Y. 1987) (provision in settlement agreement—that if debtor defaulted then creditor could proceed to collect the entire amount of judgment debt—was not an invalid "ipso facto" clause). In other words, the settlement agreement should be drafted so that the original claim does not immediately disappear on payment but survives until the retention of that payment is certain. While this is the logical and fair result of such an agreement, there is no guarantee that it will survive a bankruptcy challenge. Nevertheless, a carefully crafted settlement agreement can maximize the plaintiff's chances of being able to assert the full amount of its claim in the event of the defendant's bankruptcy. Finally, another way to manage way to reduce the avoidance risk is to source the settlement payments from earmarked funds provided by a third party who effectively steps into the shoes of the debtor, so that there is no overall effect on the debtor's balance sheet—meaning no reduction in the net dollars available to the bankruptcy estate for use to satisfy creditor claims. For earmarking to be effective, the settling parties must adhere to specific guidelines: (1) the payor and the party that ends up in a bankruptcy case must agree that the new funds will be used specifically to pay the future debtor's antecedent debt and (2) the agreement must state that the future debtor does not have any control over the disposition of the earmarked funds. For an attempt

to rely on the earmarking doctrine to be successful (1) the party receiving settlement funds should retain evidence that the agreement has been performed according to its terms and (2) the transaction should not negatively impact the debtor's balance sheet, for example, by replacing an unsecured obligation with a secured obligation. For more information on preference liability, see [Preferences](#) and [Fraudulent Conveyances versus Preference Actions](#). For information on fraudulent conveyances, see [Fraudulent Transfers](#).

## Bankruptcy Court Approval of Settlements

If the party asserting a claim files for bankruptcy relief, any settlement agreement will be subject to approval by a bankruptcy judge, who will determine if such settlement is fair to such debtor's estate and creditors. On motion by the debtor in possession or trustee, and after notice and a hearing, a court may approve a compromise or settlement. The court must decide whether "the compromise is fair, reasonable, and in the best interest of the estate." As the Third Circuit has noted, "[u]nder the 'fair and equitable' standard, [courts look] to the fairness of the settlement to the other persons, i.e., the parties who did not settle." *Will v. Northwestern Univ. (In re Nutraquest, Inc.)*, 434 F.3d 639, 645 (3d Cir. 2006). Furthermore, "[i]n the final analysis, the court does not have to be convinced that the settlement is the best possible compromise. Rather, the court must conclude that the settlement is within the reasonable range of litigation possibilities." *In re World Health Alternatives, Inc.*, 344 B.R. 291, 296 (Bankr. D. Del. 2006); see also *In re Penn Cent. Transp. Co.*, 596 F.2d 1102, 1114 (3d Cir. 1979). The debtors carry the burden of persuading the court that the compromise falls within the reasonable range of litigation possibilities. *In re A & C Properties*, 784 F.2d 1377, 1381 (9th Cir. 1986). Therefore, litigants must be aware of the very real possibility that their mutually agreed-upon settlement terms might be rejected by a bankruptcy court.

When considering the best interests of the estate, a bankruptcy court must "assess and balance the value of the claim that is being compromised against the value to the estate of the acceptance of the compromise proposal." *Jeffrey v. Desmond*, 70 F.3d 183, 185 (1st Cir. 1995). In striking this balance, courts typically should consider the following factors: (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. See *Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390

U.S. 414, 424 (1968). For more information, see [Rule 9019 Settlement Agreements](#).

## Settlement Agreement Checklist

A claimant (i.e., a potential creditor in a bankruptcy) should consider the following items when entering into a settlement agreement with a defendant (i.e., a potential bankruptcy debtor):

- Is claimant being paid in full upfront?
- Is the defendant (a potential debtor under the Bankruptcy Code) being released or are the claims being dismissed with prejudice 91 days after I am being paid in full?
- Is the defendant making the settlement payment or payments or is a third party making the payment or payments on behalf of the defendant?
- If claimant is not being paid in full upfront, is there any security for the payment obligations? If there is a security, answer the following questions:
  - Will claimant have a lien and/or security interest?
  - Will claimant have another form of payment security, such as a guaranty (possibly a bad-boy guaranty)?
  - Is the collateral being provided sufficient to cover the settlement obligation?
  - Has the lien or security interest securing the settlement payment been perfected?
  - If not, when will the recording of the interest take place?
- If claimant is releasing claims in exchange for a structured settlement, does claimant 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 claimant shall maintain the right, in the event that a bankruptcy or other insolvency proceeding is filed by the defendant, to seek an exception to discharge if the settlement amount in question is not otherwise paid in full?

A defendant (i.e., a potential bankruptcy debtor) should consider the following items when entering into a settlement agreement with a claimant (i.e., a potential creditor in a bankruptcy):

- Has the settlement amount been negotiated with the understanding of the defendant's bargaining power to

agree to bankruptcy protective provisions in favor of the claimant, in exchange for a lower settlement amount?

- Does the settlement agreement provide for a security interest or lien to secure the settlement? Are there any third-party guarantors of the settlement?
- Has claimant, as a potential debtor under the Bankruptcy Code, exposed itself to the risk that, despite the settlement, it could still be subject to an objection to discharge in a bankruptcy case?
- Is there a provision in the agreement which would support an argument that the settlement releases the defendant from an objection to a discharge in a bankruptcy case?
- Do the facts giving rise to the claim fall within an exception to discharge under Section 523(a) of the Bankruptcy Code?
- Does the settlement agreement provide for a lien or security interest to avoid litigation over dischargeability?

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### **Ira L. Herman, Partner, Blank Rome LLP**

Ira Herman concentrates his practice on restructuring and bankruptcy matters with emphasis on distressed public debt issues, secured and unsecured loans, cross-border insolvency matters, distressed M&A, and corporate governance.

#### **Restructuring & Bankruptcy**

Ira regularly advises his clients, including equity investors and lenders, on the management of bankruptcy risk in their transactions, asset dispositions, inter-creditor issues, and distressed M&A. He also regularly counsels indenture trustees regarding defaulted public debt issue. Additionally, he provides restructuring and bankruptcy advice to financially distressed businesses and their management, including with regard to corporate governance issues.

#### **Mediation & Arbitration**

As a court-appointed mediator, Ira has been able to facilitate the resolution of controversies involving U.S. and non-U.S. parties concerning bankruptcy and commercial law issues. He is a skilled listener who is able to solve problems and address the needs of the parties to a dispute by employing his knowledge of the law and creativity.

With all his clients, Ira seeks to be a partner and trusted adviser who works hard to understand a client's business to achieve the best possible outcomes. He strives to be efficient, cost effective, and proactive in discussing the impact of legal trends on their businesses, managing risk, and making the client's job as stress-free as possible.

Ira annually updates "Anticipating and Managing Bankruptcy Risk," a series of articles he has written for the Financial Restructuring & Bankruptcy module of *LexisNexis Practical Guidance*<sup>®</sup>. He has served for five years on its editorial advisory board and has also served on Law360's Bankruptcy Editorial Advisory Board. In 2022, Ira updated the chapter titled "Bankruptcy" in the treatise *Negotiating and Drafting Commercial Leases* (2022, Full Court Press).

During law school, Ira served as the Articles Editor for the Boston University International Law Journal and while earning his bachelor's degree, he served as editor-in-chief of *The Polis*, the college political science journal.

#### **Outside the Firm**

With an English Setter of their own, Ira and his wife foster and provide hospice care (when necessary) for English Setters, in association with A Better English Setter Rescue. Ira is an avid perennial gardener and has an extensive collection of 19th century bankruptcy court documents, as well as a collection of Holy Land postal history items. He is a New York sports fan and has the dubious distinction of owning the blog *Long-Suffering Jets Fan*. In addition to these interests, he enjoys spending time with his five grandchildren.

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