POTENTIAL PITFALLS FOR PLAINTIFFS AND THEIR PRE-PETITION SETTLEMENT AGREEMENTS

James S. LaMontagne

Sheehan Phinney Bass & Green

Settlements are intended to bring finality to legal disputes. Typically, settlements require 1) the defendant to pay money to the plaintiff; 2) the plaintiff to release the defendant from any and all claims that the plaintiff may have against the defendant; and, 3) the dismissal of the underlying litigation. What happens, however, when a defendant, after executing the settlement agreement and making partial or full payment under the settlement agreement, files for bankruptcy? Unless, as plaintiff's counsel, you have anticipated and prepared for a potential bankruptcy filing in your settlement agreement, you may not want to know the answer.

A. Preference Exposure

Payments under a settlement agreement are subject to avoidance under section 547 of the Bankruptcy Code. As such, your client may be forced to return money it rightfully received under a properly negotiated settlement agreement. Section 547 of the Code allows a trustee to avoid any transfer of an interest of the debtor in property—

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made—

(A) on or within 90 days before the date of the filing of the petition; or

(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if—

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

Accordingly, almost any payment made pursuant to a settlement agreement is subject to a preference attack by a trustee appointed in a subsequently filed bankruptcy case. The question becomes: can anything be done to completely insulate a client from a potential preference claim stemming from its receipt of payments under a settlement agreement. Depending on the circumstances of your settlement, the answer is probably "no", however, there are certain steps one can take to make a preference claim less likely. They include:

1. Structure settlement payments so that payments never exceed, over a 90 day window, $600 for a debtor with primarily consumer debts and $6,225.00 for a debtor with primarily non-consumer debts. See §547(c)(8) and (9). This would obviously be very difficult in cases involving large claims.

2. Structure the settlement so that payments over a 90 day period never exceed the venue limitations contained in 28 U.S.C §1409(b) ($18,675 for consumer and $12,475 for commercial). This may not prevent a preference action but it may cause the plaintiff to think twice about bringing the action if it has to travel to another jurisdiction.

3. Get settlement payment(s) as quickly as possible to start the 90 day clock running.

4. Obligate a third party to make the settlement payments. Under the Bankruptcy Code, only that property in which the debtor has an interest in may be recovered. Payments made by a principal of the defendant, a guarantor or pursuant to an annuity may provide a defense to a preference defendant.

5. Secure the payment obligation under the settlement agreement by taking a lien or mortgage to secure the settlement payments. If the lien or mortgage is not voided as a preference, the preference defendant, as a secured creditor, may escape preference liability because the trustee cannot prove that the secured creditor/preference defendant received more than it would have in the bankruptcy.

Preserving The Dischargeability Action

A settlement agreement may resolve what would otherwise be a non-dischargeable debt under 11 U.S.C. 523(a). The inherent risk in such a situation is if the settlement payment(s) is avoided as a preference or fraudulent transfer and the settlement agreement is construed as a novation or creating a new obligation, the plaintiff loses the settlement funds and its right to assert that the underlying debt is non-dischargeable in the defendant's subsequent bankruptcy case. As a result, the Plaintiff may be left with a general unsecured claim with little hope of recovery.

There are several ways, in addition to the strategies outlined above in Section A, that a plaintiff can avoid this potential problem.

First, know and understand the elements of the potential section 523(a) actions that may be relevant to your claims.

Second, state with particularity, and stipulate to, those specific facts necessary to establish a claim under section 523(a). 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."). A simple 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. See, *Double v. Cole* (In re Cole), 428 B.R. 747, 753 (Bankr. N.D. Ohio 2009) ("[T]he court can see no basis to diverge from applicable precedent whereby bankruptcy courts refuse to recognize prepetition agreements executed by debtors to waive the discharge of a particular debt."); See Also, *Klingman v. Levinson*, 831 F.2d 1292, 1296 n.3 (7th Cir. 1987) ("For public policy reasons, a debtor may not contract away the right to a discharge in bankruptcy."); *Nw. Bank & Trust Co. v. Edwards* (In re Edwards), 439 B.R. 870, 874 (Bankr. C.D. Ill. 2010) ("For public policy reasons, the right to a discharge in bankruptcy may not be contracted away."); *Simmons Capital Advisors, Ltd. v. Bachinski* (In re Bachinski), 393 B.R. 522, 533 (Bankr. S.D. Ohio 2008) ("[A] prepetition waiver of discharge entered into in a nonbankruptcy case is unenforceable."). It is also not sufficient if the settlement agreement simply states that the basis for the claim is alleged fraud. See *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).

Conclusion

Settlement agreements often involve defendants who are financially distressed and therefore more likely to file bankruptcy. Accordingly, it is good practice for any plaintiff's lawyer to consider the avoiding powers of a debtor or trustee and dischargeability issues as she negotiates and drafts a settlement agreement.