

ORANGE COUNTY BAR ASSOCIATION
BUSINESS LAW COMMITTEE

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BANKRUPTCY PROOFING SETTLEMENT AGREEMENTS

Presented by:



Roman V. Hammes, Esq.
Wolff, Hill, McFarlin & Herron, PA
(407) 648-0058
rhammes@whmh.com



Michael Nardella, Esq.
Burr Forman LLP
(407) 540-6620
mnardella@burr.com

I. Waiver of rights arising under the Bankruptcy Code

A. Issue most commonly arises in forbearance agreements in the real property foreclosure context

B. Generally, public policy prohibits the pre-petition waiver of protections afforded by the Bankruptcy Code

1. see *In re Huang*, 275 F.3d 1173 (9th Cir. 2002)

C. Waiver of Automatic Stay

1. Unenforceable

a. *Farm Credit of Central Florida v. Polk*, 160 B.R. 870 (M.D.Fla. 1993) (pre-petition waiver not per se binding on debtor as a matter of public policy)

b. *In the Matter of Pease*, 195 B.R. 431 (Bankr. D.Neb. 1995) (pre petition waiver is per se unenforceable)

c. *In re DB Capital Holdings, LLC*, 454 B.R. 804 (Bankr. D.Col. 2011) (pre-petition waivers unenforceable unless part of a prior bankruptcy proceeding)

2. Enforceable in certain circumstances
 - a. *In re Bryan Road, LLC*, 382 B.R. 844 (Bankr. S.D.Fla. 2008)
(Factors to consider in determining whether to enforce waiver: (1) the sophistication of the party making the waiver; (2) the consideration for the waiver, including the creditor's risk and the length of time the waiver covers; (3) whether other parties are effected including unsecured creditors and junior lienholders; and (4) the feasibility of the debtor's plan.)
 - b. See also *In re Citadel Properties*, 86 B.R. 275 (Bankr. M.D.Fla. 1988); *In re Club Tower, L.P.*, 138 B.R. 307 (Bankr. N.D.Ga. 1991); *In re South East Financial Associates Inc.*, 212 B.R. 1003 (Bankr. M.D.Fla. 1997).
3. Per se enforceable against a debtor unless an interested third party objects
 - a. *In re Cheeks*, 167 B.R. 817 (D.SC 1994)

II. Ipsa Facto Clauses

A. Clause that provides recourse to a creditor in the event a party to a settlement agreement files bankruptcy

1. springing recourse, bad boy recourse, exploding recourse, etc.

B. First party: recourse against debtor if debtor files bankruptcy

1. *In re Pak*, 252 B.R. 215, 217 (Bankr. M.D. Fla. 2000) ("A creditor cannot force a default upon a debtor by the use of the ipso facto clause of a contract solely because of a bankruptcy filing.").

-see also *In re Ernie Haire Ford, Inc.*, 403 B.R. 750, 758 (Bankr. M.D. Fla. 2009) ("Many courts noted that the enforcement of such clauses 'worked substantial injustice and frustrated the salutary purpose of the reorganization provisions.'").

2. but see *First Nationwide Bank v. Brookhaven Realty Associates*, 223 A.D. 2d 618, 620, 637 N.Y.S. 2d 418, 421 (1996) ("Once the bankruptcy proceeding terminated the enforceability of that clause was to be determined by State law and the contract between the parties.").

3. As many bankruptcies fail and are dismissed, it is still possible to enforce such a clause first party against the former debtor once the case is dismissed.

C. Third party: recourse against co-debtor if debtor files bankruptcy

1. *Liberty Mut. Ins. Co. v. Greenwich Ins. Co.*, 417 F.3d 193, 198 (1st Cir. 2005) (an "ipso facto clause is intended to protect a bankruptcy debtor, not a third party").
2. *FDIC v. Prince George Corp.* (4th Cir. 1995) (public policy does not prevent a bad boy guarantee from being triggered by the bankruptcy filing of the principal entity)
3. Note, no case in Florida on this issue. Cases in NY, AL, and NJ all support this proposition, and have been used successfully by plaintiffs as precedent.
4. see also *Wells Fargo Bank v. Kobernick* (5th Cir. 2011); *111 Debt Acquisition v. Six Ventures* (6th Cir. 2011)

D. Examples of Ipso Facto Clauses in Settlement Agreements

1. Contingent releases
2. Bankruptcy Default Clause
3. Cram down protection provisions
4. Recourse provisions

III. Preferential Transfers

A. 11 U.S.C. § 547

1. a trustee can potentially 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 on or within 90 days before the filing of the bankruptcy petition; that (5) enables a creditor to receive more than the creditor would have received if the transfer had not been made and the estate was liquidated under chapter 7 of the Bankruptcy Code

2. Types of preferences- \$, security interests, property
3. for general overview of preferences, see *In re Barber*, 2006 WL 2398775 (Bankr. M.D. Fla. 2006)

B. Settlement Agreement Considerations

1. section 547 excepts certain transfers from being avoided by a trustee
 - a. 547(c)(1): contemporaneous exchange for new value
 - b. 547(c)(9): in a non-consumer debt case, if the aggregate value of the property transferred is less than \$5,850, then the transfers cannot be avoided as preferential
2. Venue of preference action under 28 U.S.C. § 1409(b)
 - a. important if dealing with out of state parties
 - b. trustee must sue in venue of creditor if:
 - i. aggregate transfers are less than \$17,575 in a consumer debt case
 - ii. aggregate transfers are less than \$11,725 in a non-consumer debt case
3. 90 day time period unless if the transfer was to an insider (which extends avoidance period to 1 year)
4. Earmarking
 - a. Pursuant to settlement agreement, debtor acquires loan from third party and directs third party to pay off antecedent debt to creditor
 - b. See *Coral Petroleum, Inc. v. Banque Paribas-London*, 797 F.2d 1351 (5th Cir. 1986)
 - c. Note: 11th Circuit has not determined that transfers made pursuant to an earmarking agreement are outside the gambit of avoidable preferential transfers- see *In re Egidi*, 571

F.3d 1156 (11th Cir. 2009) and *In re ATM Financial Services, LLC*, 2011 WL 2580763 (Bankr. M.D. Fla. 2011)

5. Protecting against preferences in a Settlement Agreement
 - a. Claw back provisions
 - b. Ipso Facto provisions
 - c. \$ Amounts
 - d. Provide value
 - e. 90 day time period

IV. Dischargeability Issues

- A. 11 U.S.C. § 523
 1. excepts certain debts from a bankruptcy discharge (i.e. debts arising from fraud, intentional torts, conversion, etc.)
 2. advantage over section 727 action
 3. can parties in state court agree that a debt will be non-dischargeable in a future bankruptcy case?
- B. Collateral Estoppel
 1. applicable to dischargeability proceedings- see *Grogan v. Garner*, 498 U.S. 279 (1991)
 - a. (1) identical issue; (2) issue actually litigated in prior case; (3) issue critical and necessary to determination
 - b. lay out elements of 523(a)(2), (4) and/or (6) in the settlement agreement
 - c. state court approval of settlement agreement/ stipulation on the record/ consent judgment
- C. 523(a)(2) and fraudulently induced settlement agreements
 1. Defendants counsel beware
 2. Where a defendant fraudulently induces a creditor to enter into a settlement/ forbearance agreement, some courts have found the underlying debt to be non-dischargeable even if the defendant was honest in the original loan transaction

3. see *In re Biondo*, 180 F.3d 126 (4th Cir. 1999); *In re Moore*, 365 B.R. 589 (Bankr. M.D. Md. 2007)

V. Other Issues

Settlement Agreement vs. Forbearance Agreement

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