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Forbearance Agreement Releases Should Be Enforced in Bankruptcy

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We've all seen it. Borrower is in financial crisis. Its loan facility is in default, and the lender stands ready to foreclose. In a desperate attempt to save the borrower's business, the parties enter into a forbearance agreement. The lender agrees to give the borrower more time to satisfy its loan obligations and allows the debtor to use the lender's cash collateral so the borrower may continue in operation. In exchange, the borrower agrees to release the lender from any and all claims that might have been brought against the lender. Unfortunately, the borrower fails to successfully restructure its financial affairs and files a petition in bankruptcy. Before long, the lender finds itself defending a lender liability action brought by a newly endowed debtor in possession (DIP), trustee or creditors' committee. The lender is accused of causing the borrower's demise.


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It is under these circumstances that the release granted the lender in the pre-petition forbearance agreement is tested. Is the borrower's pre-petition release of any and all claims against the lender enforceable against the DIP, trustee or creditors' committee? In other words, if the releasor becomes a debtor in a bankruptcy case, can a bankruptcy trustee, creditors' committee or the debtor, as a representative of the bankruptcy estate in a chapter 11 case, prosecute claims that were released before the bankruptcy filing? Though there is surprisingly scant case law on this issue, this article will explain why pre-petition forbearance agreement releases should be enforced in bankruptcy.

About the Author

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To the extent that the released claims and rights arose under applicable nonbankruptcy law (such as a claim for aiding and abetting breach of fiduciary duty or under a theory of deepening insolvency), a prebankruptcy release should be enforceable. This conclusion follows the general principle that the bankruptcy estate acquires only the property and claims of the debtor as they existed immediately before the bankruptcy case was filed.[1] Thus, if the debtor gave up its claims before the bankruptcy was filed, the released claims are not property of the bankruptcy estate and cannot be brought by a DIP. Further, it is well established that a trustee in bankruptcy stands in the shoes of the debtor and takes subject to all defenses that might have been asserted against the debtor.[2]

Therefore, if the release would bar claims by a debtor, the release should also bar claims by its successor-in-interest, the trustee.

However, the issue of whether a prebankruptcy release binds third-party creditors not privy to the contractual release is tougher. Specifically, there is a line of authority, mostly in the area of pre-petition waivers of the automatic stay, that holds that prior to bankruptcy, a debtor may not waive bankruptcy rights that inure to the benefit of unsecured creditors not party to the waiver. Thus, even those courts that enforce automatic stay waivers against the debtor recognize that they may not be binding on objecting third-party creditors.[3] These courts recognize that there are certain rights, benefits and privileges—such as the automatic stay—that are created by the Bankruptcy Code for the benefit of creditors and that these credi-

Feature

1 Under 11 U.S.C. § 541(a), the bankruptcy estate is composed of all legal and equitable interests of the debtor in property as of the commencement of the bankruptcy case. The legislative history of § 541(a) explains that the "scope of this paragraph is broad. It includes all kinds of property, including tangible or intangible property, causes of action." H.R. Rep. No. 95-595, at 367-68 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6323; S. Rep. No. 95-989, at 82-3 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5785, 5868. *See also In re Van Dresser Corp.*, 128 F.3d 945, 947 (6th Cir 1997) (prebankruptcy tort claim becomes property of bankruptcy estate); *In re Ryerson*, 739 F.2d 1423, 1425 (9th Cir. 1984) (right to receive contract value earned prebankruptcy becomes property of bankruptcy estate).

2 *See, e.g., Mosier v. Callister, Nebeker & McCullough*, 546 F.3d 1271, 1275 (10th Cir. 2008) ("[T]he trustee stands in the shoes of the debtor and can take no greater rights than the debtor himself had." (citation omitted)); *Sender v. Simon*, 84 F.3d 1299, 1305 (10th Cir. 1996) ("[A trustee's] success or failure on the merits is determined as if the debtor entity itself brought the claims at issue under the applicable law."); *Hays & Co. v. Merrill Lynch, Pierce, Fenner & Smith Inc.*, 885 F.2d 1149, 1154 (3d Cir. 1989) ("The trustee is…subject to the same defenses as could have been asserted by the defendant had the action been instituted by the debtor."); *In re Magnesium Corp. of Am.*, 399 B.R. 722, 757-58 (Bankr. S.D.N.Y. 2009) (trustee can assert causes of action possessed by debtor, as its successor in interest, but trustee is also "subject to defenses that could be asserted against the debtor").

3 *See, e.g., In re South East Fin. Assocs. Inc.*, 212 B.R. 1003, 1004 (Bankr. M.D. Fla. 1997) (pre-petition forbearance agreement waiver of bankruptcy benefits may be binding on debtor, but is not binding on third-party creditors); *In re Atrium High Point Ltd. P'ship*, 189 B.R. 599, 607 (Bankr. M.D.N.C. 1985) (pre-petition forbearance agreement waiver by debtor of automatic stay would bind debtor but could not bind nine objecting third-party creditors who were not party to agreement); *In re Cheeks*, 167 B.R. 817, 819 (Bankr. D. S.C. 1994) (while objections by other parties in interest to stay relief will be heard, court will give no weight to debtor's objection, which was in conflict with and in derogation of debtor's previous agreement).

tors should therefore not be bound by a release to which they were not a party.[4]

Similarly, claims that do not exist until the filing of a bankruptcy case may not be released by a prebankruptcy release signed by the debtor. The clearest examples of these claims or rights are the bankruptcy avoiding powers for preferential and fraudulent transfers that can only be asserted by the trustee or a DIP after a bankruptcy filing. Likewise, no court has ever enforced a pre-petition agreement that prohibits the filing of a voluntary petition altogether. These agreements are deemed to be unenforceable on public policy grounds.[5] In the same fashion, the prebankruptcy waiver of the bankruptcy discharge was held to be unenforceable as a matter of public policy.[6] These decisions refuse to enforce contractual waivers of "bankruptcy benefits" conferred by the Code.

Yet most forbearance agreement releases do not attempt to override provisions of the Code or deny debtors—and their creditors—the rights, privileges and benefits it confers. Rather, the typical forbearance agreement release provides that the lender be relieved of affirmative claims and causes of action that might otherwise be brought by the debtor in exchange for the lender's agreement to forbear. As consideration for giving a borrower breathing room to work its way out of a financial crisis and the opportunity to restructure, the lender asks that the debtor grant a release of all claims that might be brought against the lender in the context of a pre-petition workout. In these situations, the lender is typically giving up valuable rights and opportunities of its own, including the right to foreclose on the borrower's assets. Moreover, the lender usually allows its borrower to use cash collateral to continue in business rather than to pay down the lender's secured debt.

When a debtor later files for bankruptcy and attempts to bring lender liability claims despite its contractual release of the lender in a pre-petition forbearance agreement, the lender's enforcement of the release is defensive. The lender seeks to uphold the pre-petition release to ward off claims by a debtor, which has already received the benefits of forbearance. Unlike cases involving waivers of the automatic stay, the right to file for bankruptcy or other fundamental "bankruptcy benefits," the lender is not using the pre-petition agreement as an offensive sword to eliminate the possibility for reorganization. Rather, the lender seeks to enforce the shield it obtained in a pre-petition agreement to defend against a lender liability attack. To invalidate the lender's release in the typical forbearance agreement scenario would deprive the lender of the benefit of its bargain and discourage out-of-court workouts.

Perhaps the best reason to enforce a pre-petition forbearance release is to encourage such workouts, which offer debtors an opportunity to restructure and often alleviate the need for bankruptcy. Thus, even in cases involving waivers of the automatic stay (which have been traditionally disfavored), numerous courts have found stay waivers to be enforceable because enforcement "furthers the legitimate public policy of encouraging out-of-court restructurings and settlements."[7] To invalidate these defensive releases in bankruptcy would thwart this fundamental policy and undermine the efficacy of out-of-court settlements between lenders and their borrowers. To be sure, a release is a "jural act of high significance without which the settlement of disputes would be rendered all but impossible."[8] Particularly when sophisticated business entities execute releases in the course of arms length negotiations—and in exchange for consideration given up by a lender—a release that is clear and unambiguous on its face must be honored and upheld. ■

4 Following this line of authority, at least one case has held in *dicta* that a debtor's pre-petition release would not bind a creditors' committee. However, the opinion was issued in the context of a discovery dispute. In *In re American Corn Sweeteners Inc.*, 248 B.R. 271 (Bankr. E.D. Pa. 2000), the court denied a defendant's motion for protective order in which it sought to avoid discovery of facts that occurred before it received a pre-petition settlement release from the debtor. The court reasoned that it could not uphold the release to prohibit discovery as to pre-release conduct where the creditors' committee had filed an adversary proceeding against the defendant, which among other claims, asserted equitable subordination. The court also observed that the release was binding on the debtor, but not on the creditors' committee. *Id.* at 275.

5 *In re Pease*, 195 B.R. 431, 432 (Bankr. D. Neb. 1996) ("It has long been settled that contractual provisions prohibiting the filing of a bankruptcy case are not enforceable."); *In re Madison*, 184 B.R. 686, 690 (Bankr. E.D. Pa. 1995) (pre-petition agreement not to file for bankruptcy for 180 days unenforceable); *In re Peli*, 31 B.R. 952, 956 (Bank. E.D.N.Y. 1983) (agreement not to file bankruptcy petition not enforceable as matter of public policy); *In re Tov Block Concrete Prods. Inc.*, 27 B.R. 486, 492 (Bankr. S.D. Cal. 1983) (same).

6 *Klingman v. Levinson*, 831 F.2d 1292, 1296 n. 3 (7th Cir. 1987) (it would be contrary to public policy to allow debtor "to contract away the right to a discharge."); *cf. In re 203 North LaSalle Street P'ship*, 246 B.R. 325, 331 (Bankr. N.D. Ill. 2000) (prebankruptcy subordination agreement to transfer to senior creditor right to vote to accept or reject chapter 11 plan not enforceable).

7 *In re Atrium High Point Ltd. P'ship*, 189 B.R. 599, 606 (Bankr. M.D.N.C. 1995); *In re Cheeks*, 167 B.R. 817, 818 ("Perhaps the most compelling reason for enforcement of the [pre-petition waiver] is to further the public policy in favor of encouraging out of court restructuring and settlements… Bankruptcy courts may be an appropriate forum for resolving many of society's problems, but some disputes are best decided through other means.") (citation omitted); *In re Powers*, 170 B.R. 480, 483 (Bankr. D. Mass. 1994) (same); *In re Club Tower*, 138 B.R. 307 (Bankr. N.D. Ga. 1991) (same).

8 *Berman v. Parco*, 986 F.Supp. 195, 208 (S.D.N.Y. 1997).

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