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Settlement agreements are intended to bring disputes to a conclusion and to allow the parties to substitute certainty for controversy. In the bankruptcy context, when the debtor or trustee agrees to a settlement, that is exactly what the parties get once the settlement is submitted to and approved by the bankruptcy court under Rules 2002(a) and 9019 of the Federal Rules of Bankruptcy Procedure. Outside of bankruptcy, however, settlement agreements provide that kind of certainty only if bankruptcy does not follow. If a settling defendant later files bankruptcy, even if it has made the full settlement payment, the consequences can be far reaching. All too frequently, settling parties structure their agreement with no consideration given to the possibility of future bankruptcy.

The risks that the potential of future bankruptcy poses to settlements are multi-faceted. The collectability of agreed payments over time is at risk. Less obvious to those not focused on the prospect of bankruptcy are the risks of preference exposure, the financial impact of losing the ability to assert the original amount of the claim and the discharge in bankruptcy of debts that would otherwise be non dischargeable. While there is no such thing as a bankruptcy proof settlement agreement, these risks can be reduced and managed to a considerable extent by awareness of the bankruptcy factor and appropriate structuring of the settlement.

Risk of Nonpayment

"Structured" settlements, involving more than just a single payment, often allow the parties to reach a resolution that otherwise would not be possible. The simplest of structures is payment over time, where the defendant agrees to pay the negotiated settlement amount in installments. The defendants likely to negotiate hardest for extended payment terms, however, also are those whose financial condition puts them at the greatest risk of bankruptcy. Obviously, if the settling defendant files bankruptcy before completing its payments, the other party may not realize the full economic value of the settlement. Taking security interests in collateral of sufficient value to cover deferred payments is the settling plaintiff's best option. Although the security interest itself may be subject to challenge as a preference, as discussed later, once the preference period passes the collateral will provide protection for the creditor's future payments even in the event of bankruptcy.

Other structures beyond a simple security interest also might be considered. If the settling plaintiff seeks a stream of income in the future, the plaintiff would be wise to create an independent source of those payments, such as an annuity, that would not require payments by the defendant itself after bankruptcy. Third-party guarantees are another source of independent payment that would not be affected by the defendant's bankruptcy. If the defendant has accounts receivable or other future expectancies of payment, these also can provide the plaintiff with an independent source of payment of which it could take an assignment.

The key consideration in minimizing the risk of payment defaults in structured settlements is to consider the negotiation of payment terms a credit decision. If the defendant is not financially solid, the settling plaintiff should not just accept an unsecured obligation to pay, but rather should take the best payment protection possible to prevent the loss of its settlement expectancy in the defendant's bankruptcy.

A settlement involving payment inherently involves the risk that the payment received by the plaintiff will be voidable as a preference if the defendant files bankruptcy within 90 days after the payment. 11 U.S.C. @ 547(b). While an argument can be made that the dismissal of litigated claims is "new value"and thereby excepted from preference risk under @ 547(c)(1), this reasoning is suspect at best and a settling plaintiff must recognize the preference risk just as any creditor receiving payment on a pre-existing debt must. While the release of claims is certainly of value to a defendant, the defendant's settlement payment is a payment on account of the plaintiff's claims, which arose out of some past transaction or event--therefore, a classic preference. See In re VasuFabrics Inc., 39 B.R. 513 (Bankr. S.D.N.Y 1984) (settlement payment is for antecedent debt even if made before signing settlement agreement). While preference exposure cannot be eliminated, the settling plaintiff can take steps to both minimize the risk of preference exposure and reduce its ultimate impact.

Again, the most important thing to recognize is that settlement payments most likely will become voidable preferences if the settling defendant files bankruptcy within 90 days after the payment. The simplest protection against this risk is for the plaintiff to take the payment as soon as possible, to start the 90-day preference period running. If the plaintiff can make it to the 91stday, the risk disappears. The sooner the time starts running, the sooner the plaintiff will reach its safe harbor.

A more unorthodox way for the plaintiff to increase its chances of making it through the preference period would be to carefully assess the defendant's financial condition and what it would take to assure the defendant's financial survival for 90 days. If the defendant is tight on cash but has some unencumbered assets, the plaintiff could defer payment for 90 days, allowing the debtor to use the cash for ongoing business and financial needs, and take a security interest in the debtor's non cash assets. While the security interest itself would be vulnerable as a preference for 90 days after perfection, if the arrangement allowed the debtor to survive through the preference period the plaintiff could be assured of ultimately realizing the value of the settlement through its collateral. This is one rather unusual scenario in which a secured payment obligation might be better than cash.

Another approach to reducing preference exposure is to build up the "new value" aspects of the settlement. If there is an ongoing business relationship between the plaintiff and defendant, future business accommodations might be worked into the settlement structure to provide some element of identifiable value, thereby raising the possibility of a new value defense to a preference challenge. The parties also can express the terms of settlement as much as possible as involving new value. Whether this kind of "window dressing" can insulate the settlement payment is doubtful, but anything the plaintiff can do to inject a basis for arguing new value cannot hurt.

Similarly, although most settlements cannot be characterized as transactions in the ordinary course of business, anything the parties can do to insert elements of ordinary course into the transaction might provide some basis for an ordinary course defense under 547(c)(2). While these kinds of efforts offer no assurance, they at least may better the odds.

Perhaps the most critical risk in settlements is the risk that the settling plaintiff will end up with neither the settlement payment it bargained for nor the ability to assert the full amount of its original claim in the defendant's bankruptcy. Without some attention to this risk, this is the likely result of most simple settlement agreements involving payment of a compromised amount. The plaintiff accepts the agreed payment from the defendant and in turn immediately gives the defendant a full release of all claims and dismisses its lawsuit with prejudice. If the settlement payment is later recovered as a preference, the plaintiff may be hard pressed to revive its original claim. The plaintiff then may be left with only an unsecured claim for the amount of the preference (i.e.,the settlement amount), to be paid cents on the dollar, rather than having the ability to receive pro rata payment for the full amount of the original claim. The plaintiff should address this risk in negotiating the terms of settlement and do whatever it can to preserve its right to assert the full amount of its claim.

This same consideration holds true for structured settlements requiring future payment. If the future payments are not made because of the defendant's bankruptcy, the plaintiff will want to preserve the ability to assert the full amount of its original claim.

Preserving the Original Claim

The typical settlement agreement, involving the exchange of a payment (or promise to make future payments) for a full and immediate release, invites the plaintiff's worst- case scenario--losing both its bargained for payment and its right to assert the full amount of its claim. To reduce this risk, the plaintiff can try to negotiate any one of several different settlement structures. Perhaps the best (but the hardest to negotiate) protection is for the defendant to stipulate to the entry of judgment for the full amount of the plaintiff's claim. The plaintiff agrees not to execute on the judgment for 90 days and to file a satisfaction of judgment if the defendant has not filed bankruptcy within that time. If bankruptcy is filed within that period, the plaintiff can assert its full claim, as supported by the amount of its judgment, in the defendant's bankruptcy. If the 90-day period passes without a bankruptcy filing, the plaintiff then has an affirmative contractual obligation to file the satisfaction of judgment, allowing the settlement to be realized in the manner intended by the parties.

A less dramatic but useful alternative in dealing with the preference risk is for the plaintiff to delay the effectiveness of the release of its claims, as well as the dismissal with prejudice of its pending litigation, until 90 days has passed without a bankruptcy filing. While such an arrangement might be subject to challenge as an "ipso facto" clause under @ 365(e), it is more likely that such a delayed release would not be deemed to have occurred in the absence of its express condition precedent and that the plaintiff would not be forced to perform its affirmative duty to dismiss in the absence of that same condition.

A settlement agreement also should expressly provide for the preservation of the plaintiff's original claim under any circumstances in which the plaintiff is not allowed to receive and retain the full amount of the cash consideration for which it bargained. 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.

Preserving Nondischargeability

A settlement may resolve a claim that would otherwise be nondischargeable under @ 523(a). In accepting such a settlement, the plaintiff should be especially careful not to bargain away its right to assert nondischargeability in the defendant's bankruptcy. Otherwise, a defendant facing liability on a nondischargeable debt could enter into a settlement involving either a lump sum payment or payment over time and then recover the payment as a preference or discharge the settlement obligation in bankruptcy. If the settlement agreement is viewed as a novation, creating a new obligation,then the plaintiff may lose its right to assert nondischargeability.

In re Warner, 283 F.3d 230 (4th Cir. 2002), the U.S. Court of Appeals for the Fourth Circuit recently reached that result, holding the plaintiff had given up its claim for a nondischargeable debt by entering into a settlement agreement and substituting a new contractual obligation. The plaintiff might well find it acceptable to substitute a certain dischargeable obligation for a disputed nondischargeable claim. Nevertheless, a plaintiff that is likely to lose the economic benefit of its settlement bargain (either by nonpayment or by avoidances a preference) is likely going to want to preserve its right to assert nondischargeability in the event of the defendant's bankruptcy.

The most straightforward way to address this risk is for the settlement agreement to explicitly state the grounds for the debt being paid, so that the debtor will be hard pressed to dispute those grounds. Rather than reciting that the debt is nondischargeable, the actual grounds for nondischargeability should be stated, consistent with the language of the applicable statutory exception to discharge. This kind of confessed nondischargeability generally will be honored. But see In re Huang, 275 F.3d 1173 (9th Cir. 2001) (agreement of nondischargeability alone not enforceable).

Since many defendants will be reluctant to confess nondischargeability, amore feasible approach is to structure the agreement so that the issue of nondischargeability is expressly preserved in the event that the plaintiff does not receive or retain the economic benefit of the settlement payment. The agreement should expressly state that it is not the creation of a new obligation, and that the plaintiff preserves its right to assert the nondischargeable nature of the debt. This can be done in conjunction with preservation of the original amount of the claim.

As in many transactional contexts, settlement agreements may not be what they seem when the possibility of bankruptcy is factored in. Settling parties must be aware of the implications of a future bankruptcy filing. With that awareness, they can negotiate agreements that will offer the best hope of preserving the intended benefits of settlement.

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